



INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

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January 10, 2011

Dear Sirs / Mesdames:

Re: Joint CSA/IIROC Position Paper 23-405 *Dark Liquidity in the Canadian Market*

The IIAC appreciates the opportunity to comment on the Position Paper. Our response is informed by an IIAC Working Group comprised of representatives from firms of varying sizes, doing business in both the retail and institutional realm.

Although we believe it is important for the regulators to understand and keep abreast of developments in the market, we hope that this Paper is an exercise in information gathering, rather than a precursor to regulation to be implemented in the short term. At present, there does not appear to be evidence demonstrating that there is a problem arising from Dark Liquidity or sufficient investigation as to the effect of such regulation to justify new regulatory initiatives.

The Working Group had the following responses to the questions, and the recommendations articulated in the Position Paper.

Question 1: Under what circumstances should Dark Pools or marketplaces that offer Dark Orders be exempted from the requirements of pre-trade transparency under NI 21-101?

CSA/IROC View: The only exemption to pre-trade liquidity should be for orders that meet a minimum size threshold.

IIAC Response: The members of the IIAC Working Group were generally not in favour of the imposition of minimum size requirements in respect of Dark Pools and Dark Orders. Given that no evidence has been presented to demonstrate that price discovery is compromised by smaller orders, there is no compelling case to introduce regulation that may not serve the intended purpose and could have unintended negative consequences.

It is important to note that the manner in which trading is conducted has changed significantly over the years since Dark Pools and Dark Orders were introduced into the market. In particular, the way in which institutions interact with liquidity pools has evolved, so that certain of the assumptions about the purpose and functioning of Dark Pools and Dark Orders may not longer be valid. For example, although an originating order may be comprised of 100,000 shares, the optimal trading strategy may result in the actual trades being conducted in much smaller increments. By imposing minimum size requirements, the traders' ability to develop tools and strategies that will best serve their clients may be compromised, leaving clients with something less than best execution.

Given that dealers are bound by best execution requirements, as well as obligations to address conflicts of interest and order exposure rules, they should be able to choose when it is appropriate to engage in the trade off between more immediate and certain matching on protected markets or to take advantage of Dark Liquidity.

Members were of the view that the vast majority of the small passive Dark Orders would not be directed to a lit market if the dark markets were not available. Contrary to the intent of the recommendations, these orders would be held "upstairs" by dealers, with the result being that there would be total less achievable liquidity exposed to the markets for execution even if that liquidity is not displayed.

Rather than attempting to regulate the dark market in the absence of evidence that it is causing a problem, regulators should consider investigating whether there is a problem in the lit markets that is resulting in small orders being sent to dark markets.

If regulators are intent on imposing a minimum size requirement, it is important that they consider current average order and trade sizes. Currently average trade sizes are trending between 200 – 400 shares, depending on the marketplace. The CSA and IROC should also look at other non-displayed orders like Minimum Guaranteed Fill sizes and iceberg orders. A minimum order size of 500 which is greater than the average order size on displayed markets would achieve the CSA and

IIROC objectives of encouraging price discovery, and would quash the very small risk-free “pinging” orders. Alternatively, restrictions could be tied to the liquidity of a security.

It is also important to note that the minimum amounts to display for iceberg orders have been shrinking over the past number of years; first from 2000 to 500 and most recently from 500 to 100 in the past year. This reduction in order size has had the support of industry and has not had a detrimental impact on the market. The introduction of the TSX Market on Close is an example of an innovation that reduces transparency has been beneficial to the market. In the case of MOC, it has reduced volatility. In any case, size restrictions for the MOC or similar facilities should not be introduced.

Question 2 & 4: **Should Dark Orders be required to provide meaningful price improvement over the NBBO, and under what circumstances? What is a “meaningful” level of price improvement?**

CSA/IIROC View: **Two Dark Orders meeting the minimum size exemption should be able to execute at the NBBO. Meaningful price improvement should be required in all other circumstances, including all executions with orders not specifically marked in a manner indicating they are utilizing the minimum size exemption.**

Meaningful price improvement means that the price is improved over the NBBO by a minimum of one trading increment as defined in UMIR, except where the NBBO spread is already at the minimum tick. In this case, meaningful price improvement would be at the mid-point of the spread.

IIAC Response: If a minimum size requirement is imposed, we agree that Dark Orders at or above the threshold should be able to execute at the NBBO. The key issues in respect of price improvement are questions about what constitutes “meaningful” price improvement, and the factors that are taken into account when calculating price improvement. Currently only the trade price is considered, without reference to the underlying costs and rebates applicable to the trade. These factors can completely change the economics of a trade for a firm and the client. The benefit on the passive side is paid for by the active fees, which, when factored in, can erode the principle of meaningful price improvement. For instance, if due to the rebate structure of a marketplace, an apparent price improvement of 50 mils costs 45 mils to achieve, the resulting actual price improvement is only 5 mils, which we agree, does not appear meaningful.

As such, in developing a regulatory model in respect of price improvement, a holistic view of the trade should be taken, which includes the effect of rebate programs. We note that the common practice in Canada is to charge for providing dark liquidity or provide little to no rebate on passive dark liquidity.

Members also suggested that a percentage benchmark against the trading price be established in respect of what is considered material.

Question 3: **Should visible (lit) orders have priority over Dark Orders at the same price on the same marketplace?**

CSA/IIROC View: **Visible orders on a marketplace should execute before Dark Orders at the same price on the same marketplace. However, an exception could be made where two Dark Orders meeting the minimum size threshold can be executed at that price.**

IIAC Response: We agree with the CSA/IIROC view that visible orders on a marketplace should execute before Dark Orders at the same price on the same marketplace. However, regulators must ensure that the recent trend for marketplaces to develop multiple books must be recognized, and not permitted as a means of circumventing this regulation.

Other Issues

Dark Pools and Dark Orders currently operate at a disadvantage to protected markets, which has resulted in the development of client focused innovations in order to attract order flow. Ultimately, investors are better served by the choices and flexibility afforded by the dark market.

We are concerned that the recommendations in the Position Paper are not based on empirical evidence about the impact of dark trading in the Canadian market. The experience of other international markets provides interesting background, however, the differences in the economic and business models, as well as our market and regulatory structure diminish the applicability of their solutions to our market.

We understand that it is important to be apprised of the possible detrimental impacts of market innovations in order to be able to act quickly where a problem becomes apparent or likely to occur. At this point, Dark Pools and Dark Orders provide dealers with flexibility and a variety of tools to achieve best execution for their clients, without demonstrable harm to the market. The current best execution requirements in the regulation ensure that clients' needs are protected. As such, the development of rules that limit their operation at this time, is premature and would likely result in a regulatory regime that may stifle innovation, and also create unintended negative consequences for clients.

We would be pleased to discuss this topic further at your convenience.

Yours sincerely,

"Susan Copland"

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