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May 31, 2019

Dear Sirs/Mesdames:

**Re: Joint CSA/IIROC Consultation Paper 23-406 Internalization within the Canadian Equity Market (the “Consultation Paper”)**

The Investment Industry Association of Canada (the “IIAC” or “Association”) appreciates the opportunity to comment on the important issues raised in the Consultation Paper. The issues raised in the Consultation Paper illustrate the complexity of topic, and the reality that market participants have diverse, but valid perspectives of the issues, depending on their business model and views as to how clients’ interests are best served.

The IIAC represents 118 IIROC members, ranging from small regional and boutique dealers to the largest integrated and bank-owned national firms. Given the differences in our members’ size and business

models, there were several issues and questions raised in the Consultation Paper where industry consensus could not be achieved. As such, in certain areas, our response will not present one unified industry position, rather, we will articulate the various perspectives of our members where there is clear divergence.

IIAC members agree that the six key market attributes of, liquidity, immediacy, transparency, price discovery, fairness, and market integrity are important to a functional and trustworthy market. Similarly, we agree that marketplace rules should provide investor choice, improve price discovery, decrease execution costs and improve market integrity.

Differences, where they exist between member perspectives on the costs and benefits of internalization and broker preferencing, is how the regulation should balance the attributes, and to what extent certain attributes should be permitted to take precedence where there is an inherent conflict between them. In short, there is a divergence of opinion as to whether, and to what degree to which the common good of the overall market should take precedence over the individual good of internalizing dealers and their clients. There is also disagreement as to whether internalization and broker preferencing enhance or detract from the common good.

All dealers agree that the internalization of large orders does not detract from market integrity, and is necessary in many cases. Members are of the view that dealers should have the option of internalizing such orders via crosses to another client or facilitated trades through inventory of the dealer, in order to avoid market disruption.

Certain members were of the view that pro orders should not be subject to broker preferencing.

Areas of disagreement as between internalizing and non-internalizing firm relate to the issues of broker preferencing, and internalization of small orders.

Some members are concerned that the Consultation Paper contains insufficient data and description of the methodology behind the data contained in the Paper. For instance, in respect of non-intentional broker preferencing, the definition should be confined to situations where the preferencing dealer trades in advance of other dealers that have orders in the queue. It should not include trades where there are no other dealers competing for the trade.

### **Internalizing Firms – General Position**

In general, the larger, bank-owned firms that undertake internalization and broker preferencing as a material part of their trading (the “internalizing firms”), emphasize the regulation goals of investor choice, better quality execution and reduction of execution costs for their clients in their support of these practices. These firms indicate that the regulation must take into account the benefits of lower costs and in certain cases, better execution for their clients resulting from internalization and broker preferencing, as against the focus on broader market goals which they believe may increase costs, reduce choice, and increase market impact for clients of these firms.

Internalizing firms’ position on broker preferencing is that it provides best execution by matching clients with each other rather than trading one client order with an intermediary and leaving the other client

unfilled. The ability to do so is a key feature a full-service dealer, and this contributes to the low cost and efficiency of trading in the Canadian equity market.

There is a concern that restrictions on internalization and broker preferencing will make dealers less efficient, increase complexity, and increase costs for the industry and clients. This would ultimately reduce Canada's competitiveness as it would become a more expensive place to trade.

In respect of internalization and broker preferencing of small orders, internalizing firms are of the view that UMIR 6.3, the Order Exposure Rule, achieves adequate transparency, price discovery, immediacy and liquidity by ensuring smaller orders are exposed to lit marketplaces, addressing liquidity, timeliness and price discovery objectives.

It was also noted that the US permits full internalization, without evidence that it has harmed that market, in that it remains the lowest cost and most liquid market globally. Although there is not support for moving to a US style structure, allowing full internalization, there is a concern that if Canada prohibits or places additional limits on internalization and broker preferencing, moving far from US practices, it will discourage global participants from sending orders on Canadian securities to our market when more favourable execution terms are available from US internalizers. Close to 2,700 Canadian securities are available for trading on US primary and OTC markets, which places our market in direct competition with US internalization across the majority of Canadian names.

There was also concern that eliminating broker preferencing and moving to a price-time allocation model would lead to additional market complexity and would be counter-productive in meeting the concerns of smaller dealers. A price-time model rewards those participants who are first to establish or join a price level which creates a natural advantage for US High Frequency Trading firms. Eliminating broker preferencing will tilt the playing field toward HFTs at the expense of Canadian retail investors (who are the primary beneficiaries of broker preferencing today), while smaller dealers may see little to no improvement in fill rates.

Eliminating broker preferencing would also create a strong incentive for larger dealers to find other means to achieve best execution for their clients. This could lead to the creation of new non-protected order books, greater investment in technology for placing and moving orders across order books or more complex order types to replicate the client benefits of broker preferencing. The higher cost and complexity of these solutions would not be a good outcome for the Canadian market.

It was also noted that Europe attempted to shift more trading to lit markets through MiFID II regulation, but dealer innovations ultimately led to an increase in off-exchange trading in response to the new rules.<sup>1</sup>

### **Non-internalizing Firms - Position**

To be clear, in respect of internalization of large orders, some smaller dealers undertake client-to-client crosses and facilitation crosses for certain large orders. This is done on a specific transaction basis, and

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<sup>1</sup> CFA Institute: *MiFID II and Systematic Internalisers: If Only Someone Knew This Would Happen*, July 2018

such firms do not have the volume of flow that would allow them to develop routing rules and systems to routinely internalize much of their trading flow.

As noted above, these firms do not object to the practice of internalization for large orders, to reduce market impact. However, these dealers do object to the practice of internalizing a significant portion of trade flow, such that an ever-decreasing number of orders can be interacted with in the order book by other participants, reducing liquidity, transparency, price discovery and fairness.

Non-internalizing firms are of the view that the key market attributes of liquidity, transparency, price discovery, fairness, are critical to and market integrity and are not supported by internalization that is not confined to large orders, and broker preferencing.

Smaller, independent and other dealers are not able to undertake broker preferencing, as they do not have a sufficient number of orders to match on real-time, ahead of other orders in the queue. This places these dealers and their clients at a disadvantage on a structural level, as their clients' orders may have delayed execution as broker preferred orders are not subject to order priority. At times, the disadvantaged clients are forced to change the terms of their passive orders in order to hit the opposite side, resulting in the clients paying more for their stock or selling at a lower price.

Non-internalizing dealers point to the statement in the notice that broker preferencing pre-dates modern electronic marketplaces and was an incentive to encourage dealers to commit orders to the order book. With the evolution of the electronic trading structure, broker preferencing should no longer be necessary.

Some members indicated that the loss of time priority has led to a situation where many orders are not posted, as it is anticipated that they will be traded around, thus, decreasing liquidity and transparency. These members believe that fragmentation, broker preferencing and routine internalization has degraded the quality of the market, and that the more this is permitted, the more orders in the market lose the benefits of being competed for.

In respect broker preferencing, the non-internalizing dealers believe that in particular, orders that are created solely to take advantage of existing orders are not appropriate. Aside from banning broker preferencing as a whole, which some members support, members indicated that another solution would be to require a delay to allow the order to be exposed, allowing competition, in order to mitigate the liquidity, and fairness issues. Once the order has been exposed for a specific time, broker preferencing would be permitted.

Most non-internalizing dealers support strict time and price priority to ensure fairness, which would effectively eliminate broker preferencing. These members believe that exposure on a marketplace should come with an opportunity for all to have a chance to trade with the order. As those orders are exposed on the marketplace and all dealers are allowed to trade with it, liquidity will be created. Where orders are intercepted without an opportunity for others to trade, the added value to the market is limited.

Non-internalizing dealers also indicated that although inverted pricing rules can mitigate the broker preferencing issue, a more coherent and consistent rule banning broker preferencing would be promote fairness, transparency, and price discovery.

Non-internalizing dealers note that the protections afforded by the Order Exposure Rule do not mitigate the effects of broker preferencing. Orders under 50 standard trading units can be exposed on a lit market, but the over-ride of priority, or pre-arranged crosses that are conducted on the market prevents other dealers from interacting with those orders, violating the fairness and in some cases, real price discovery. Firms want to have fair competition to access a quote. Where these firms are providing price discovery through providing the quote, but they are not able to interact with the flow on a fair basis, this diminishes the perception of the market as a fair and desirable place to trade. These dealers support a requirement that orders under 50 standard trading units should go to the top of the book, so that all dealers have the opportunity to trade with such orders. This addresses the fairness issue, and does not compromise investor interest, as the order will be filled, but in time priority order.

The perception of these firms and their clients that the market is unfair may ultimately undermine investor confidence, diminishing the vitality and integrity of the market in general.

In respect to the observation that full internalization and wholesaling is undertaken in the US, without a degradation of market integrity, non-internalizing dealers indicate that the US market is significantly larger than the Canadian market, and in that context, this form of internalization is intended address the need for immediacy in that market, as timing is critical to their clients. In Canada, a much smaller and less liquid market, price discovery is a much higher priority.

Non-internalizing dealers believe, in contrast to the internalizing dealers, that northbound flow is decreasing due to market fragmentation, and that allowing more internalization and broker preferencing would exacerbate the problem. Ultimately, these dealers believe broker preferencing is unnecessary, and unfair and should be prohibited.

### **Possible Implications of Regulation**

The nature of the situation is that regardless of whether broker preferencing is restricted or not, certain clients may feel they are disadvantaged. Current clients of internalizing firms that use broker preferencing will have a reduced experience in terms of execution quality and perhaps increased cost if their order is traded away from the firm. On the other hand, firms that are unable to utilize broker preferencing currently experience a reduced client experience through inferior execution when other orders are preferenced and trade ahead of their orders.

Once of the implications of restricting broker preferencing is that in order to address the lost efficiencies, and deal with the significantly increased trading and settlement costs, firms may create other systems in order to serve their clients needs and achieve the benefits of broker preferencing, potentially creating other negative unintended consequences for the market. For instance, such rules may create incentives for dealers to post on marketplaces with less liquidity and then re-route their orders there.

Members indicated that creation of rules to limit broker preferencing should look to Europe where MiFid intended to limit internalization and resulted in less visible orders.

Non-internalizing dealers indicate that they have been subject to the high trading and settlement costs, unmitigated by broker preferencing, so rules would level the playing field.

Members all agree that internalization of large orders is acceptable and assists the client and the market in terms of reducing costs and market impact. These large, high market impact orders include both retail and institutional orders. The market impact of orders in Canada is particularly high. Large size orders trade through multiple price levels, increasing costs and market impact. If internalization is prohibited for large orders, the result would be a large amount of algorithmic trading designed to disguise large trades to reduce market impact. This may result not only in increased trading costs, but in orders being in the marketplace all day, which increases risk.

There is less agreement in respect of internalization of small orders. Members agree that the Order Exposure Rule provides some useful limitations, requiring certain orders to occur on the lit markets. This does not, however, address the concerns with broker preferencing, and there is some disagreement as to whether the threshold for a small order under the Order Exposure Rule is too low.

Thank you for considering our comments. If you have any questions, please don't hesitate to contact me.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'S. Copland', written in a cursive style.

Susan Copland