**CANADIAN SECURITY TRADERS ASSOCIATION, INC.**
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**Re: Re-Publication of Proposed Dark Rules Anti-Avoidance Provision**

The Canadian Security Traders Association, Inc. is a professional trade organization that works to improve the ethics, business standards and working environment for members who are engaged in the buying, selling and trading of securities (mainly equities). The CSTA represents over 850 members nationwide, and is led by Governors from each of three distinct regions (Toronto, Montreal and Vancouver). The organization was founded in 2000 to serve as a national voice for our affiliate organizations. The CSTA is also affiliated with the Security Traders Association (STA) in the United States of America, which has approximately 4,200 members globally, making it the largest organization of its kind in the world.

This letter was prepared by the CSTA Trading Issues Committee (the "Committee" or "we"), a group of 21 appointed members from amongst the CSTA. This committee has an approximately equal proportion of buy-side and sell-side representatives with various areas of market structure expertise, in addition to one independent member. It is important to note that there was no survey sent to our members to determine popular opinion; the Committee was assigned the responsibility of presenting the views of the CSTA as a whole. The views and statements

provided below do not necessarily reflect those of all CSTA members or of all members of the Trading Issues Committee.

We appreciate the opportunity to comment on the proposed provisions related to the application of Canada's dark rules to trading outside of marketplaces within Canada.

We understand and acknowledge the stated policy objective of ensuring that any broad-based routing of retail flow to foreign markets does not deny the Canadian markets of the benefits of this flow for a de minimis price improvement not otherwise permitted in Canada. We believe that retail activity by Canadians is important to the overall health of the Canadian marketplace. In an extreme case, if all retail flow were to be routed to bilateral counterparties and denied the opportunity to trade in the Canadian markets, we believe that the integrity of the Canadian lit quote would be at question.

The systematic internalization of Canadian retail flow in U.S. retail-oriented dark markets has the effect of removing active order flow from Canada. This ultimately reduces the amount of liquidity available to the individuals that are represented by Canadian institutions working orders domestically. We also question whether routing practices that systematically and substantially divert order flow away from Canada are for the sole benefit of the retail client or if the practice is designed primarily to manage dealer costs. We would expect such decisions to be subject to regulatory scrutiny related to best execution.

**Routing Practices: Retail and Institutional**

The Canadian regulatory framework has significant provisions that preclude the systematic internalization or wholesaling of domestic retail order flow. These provisions include:

- A ban on payment for order flow.
- The requirement that any entity that uses established, non-discretionary methods of matching buyers and sellers be considered a marketplace and therefore subject to all marketplace provisions including fair access.
- A dark trading regime which significantly curtails the economics of liquidity provision in limited-access dark markets such as the model of Alpha IntraSpread prior to October 15th, 2012.

We are generally supportive of provisions that maintain the integrity of the Canadian lit market. Moreover, as a matter of principle, we believe that rules enacted in Canada should be applicable uniformly across jurisdictions. A form of regulatory arbitrage brought forth by changing the domicile of execution or counterparty does not benefit the Canadian market and instead undermines the purpose of Canadian regulation.

The policy objective of the proposed provisions appears to be to ensure that Canadian dealers cannot systematically route Canadian flow to dark FORMs in the U.S. which systematically internalize order flow. It is important to note that the order flow that is generally subject to

such order handling is retail flow, because retail orders are typically independent of each other and represent low risk to market makers. Retail orders are likely to be routed to U.S. dark markets/destinations which are specifically designed to give retail market making firms an opportunity to internalize flow without being subject to adverse selection, while utilizing price discovery in the lit markets. An example of such a market is the NYSE Retail Liquidity Programme.

On the other hand, the economics of wholesaling for institutional orders may not be as significant because the order flow is typically considered to be directional or "informed." Quite simply, institutional orders typically aren't purchased by retail wholesalers (or routed to retail internalization dark pools) because the flow is unprofitable to strategies targeting retail activity. Instead, institutional order routing to U.S. dark markets is typically done to manage information leakage, for size discovery, and for dealer cost management. We do not believe that the majority of institutional orders are systematically routed to the U.S. for any reasons outside of best execution in the context of the market at the time of the order.

We believe the institutional usage of the U.S. dark FORM's is different from retail, and thus the application of Canadian dark rules to institutional order handling should also differ from retail. The policy objective of the proposed provisions focuses on retail order routing, and therefore we believe the proposal should attempt to minimize unintended impact on non-retail segments of the market.

**Exemptions for "Large" Orders**

The rules propose a carve-out for orders larger than 50 board lots or $100,000 in value ("large orders"). While well-intentioned, we believe the application of this exemption introduces significant practical issues which would generally render the carve-out as substantially meaningless.

Most importantly, institutional orders – which may well be "large" – are frequently divided into smaller orders which individually would not qualify for the exemption. These smaller orders can be generated by algorithmic systems, split by individual traders into smart routers, or otherwise handled by downstream systems. Each of the downstream systems handles a child order of the larger institutional order as though it is the "entire" order and has no visibility into the overall whole. A similar problem arises when handling institutional basket orders which may comprise many orders, each "small," with no ability for systems to discern that the whole is outside the spirit of the proposed provisions.

From a rule compliance standpoint, each intermediate system in an order handling chain (the OMS, the algorithm suite, the smart router, etc.) would need to be modified to allow an upstream component to indicate the size of the "parent" order and whether an anti-avoidance exemption is in effect. Without such modifications the proposed provisions would effectively apply to a significant portion of institutional orders, which is at odds with the stated policy goals of managing the behavior of retail order execution.

**Southbound Relationships**

Currently many Canadian dealers rely on their U.S. counterparts for southbound execution, either as related parties or at arms-length. The orders that are sent to U.S broker-dealers are subject to best execution requirements, and some US broker-dealers will route to dark markets because it is appropriate for best execution, notwithstanding costs.

The proposed rule would require that an order that is routed southbound for execution be directed either to lit markets or to dark markets which offer a suitable minimum price improvement relative to the Canadian quote. This raises a number of practical issues that would disadvantage Canadian dealers:

- Orders in interlisted securities sent to the U.S. for execution do not contain a reference Canadian quote for determining which dark markets may be accessed and at which prices. The U.S. executing brokers would not be able to determine suitable U.S. execution prices, because the broker would not know what foreign exchange rates would apply to the Canadian dealer routing the order.
- Canadian dealers may be forced to specify separate lit and dark prices on each order routed southbound. A provision for a second price field on each order would require changes to order routing technology for both the Canadian and U.S. firms. Such a change would be costly to implement for both Canadian dealers and U.S. executing brokers.
- Forcing execution to occur only in lit markets would dramatically raise the cost of execution for dealers with southbound flow, as lit markets are generally more expensive than dark. This would reduce the competitiveness of Canadian dealers competing globally for internationally-originating flow in Canadian stocks, as dealers registered in other jurisdictions would face greater execution options and a lower cost structure than Canadian dealers.

The technology changes required to comply with the proposed rule, while remaining as competitive as possible, are to complex and costly to implement for the community. Most importantly, some of the necessary changes must take place at the US executing brokers, who may be reluctant to commit resources for the purpose of compliance with exemptions to anti-avoidance. In practice, this may mean that the necessary technology work would not occur on a level which permits Canadian dealers to maintain competitiveness with global peers. This would have the effect of permanently disadvantaging Canadian dealers, and the institutions they represent, in a globally competitive marketplace.

**Recommendations**

We agree with the intention of preserving the integrity of the Canadian market by taking steps against the systematic internalization of retail orders, regardless of jurisdiction. Systematically routing orders away from the Canadian visible market carries with it an implied cost to those

who choose to participate in lit price discovery and whose fill rates are reduced through this practice.

We note that some aspects of potentially harmful order routing practices (such as execution outside of the Canadian CBBO when fees are included in the price comparison with the U.S. quote) are a best execution matter notwithstanding whether the execution was dark or lit. If a decision is made to route a particular order away from Canada for best execution reasons, we agree that it is appropriate to require that it be executed on a FORM (subject to appropriate exemptions for block trading). Additionally, we believe that dealers choosing to systematically route retail order flow to internalization markets or counterparties (which may be considered a FORM) should be required to demonstrate the unequivocal benefits of the practice. If price improvement is received when routing retail order flow to the US dark markets (including the impact of foreign exchange), the entirety of the price improvement should also be passed on to the end clients.

On balance, we believe that while the intentions of the proposed anti-avoidance provisions are sound, the breadth of the application may outstrip the policy objective of addressing retail routing practices. The principles of anti-avoidance would be better expressed as guidance for the execution of retail order flow (rather than a rule change) and enforced through a review of dealer activity, ensuring that order routing is consistent with the spirit of the Canadian dark rules. This would restrict the application of the anti-avoidance provision to the sources of flow which are likely to be internalized, and where the potential for harm to the market is greatest. Dealers offering execution services for institutional clients, domestic or international, would not be unduly affected as their practices would remain rooted in the execution needs of their clients, be subject to their clients' best execution scrutiny, and be subject to competitive forces from both domestic and international sources. This would lead to an environment where institutional activity is handled in accordance to global institutional best practices, and the Canadian lit market is not unduly deprived of the benefits of Canadian retail flow.

**Answers to Specific Questions**

1. *Are there alternative approaches which would ensure that the policy objectives of the Order Exposure Rule and the dark liquidity framework are achieved?*

See above.

2. *Are U.S. dollar denominated accounts, by their nature, distinct from other client accounts such that they should be permitted to trade in the U.S. without reference to the CBBO? If an exception to UMIR 6.3 existed for U.S. dollar denominated accounts, could the exception be exploited contrary to the principles espoused in the Order Exposure Rule?*

We believe that U.S. dollar denominated accounts are generally intended to transact without reference to the Canadian market, as Canadian execution would necessarily subject such an account to foreign exchange translation requirements. The efficiency of trading in the native

currency of the account – the U.S. dollar – suggests that execution for such accounts would naturally gravitate towards the U.S. market, and they should be considered U.S. accounts for practical purposes. We therefore believe that such accounts should be permitted to trade without reference to the CBBO.

3. *Does the proposed implementation date of 90 days following the publication of the notice of approval of the Proposed Amendments provide sufficient time to accommodate any development work that may be required to be performed by Participants?*

We believe that the technology changes required to allow complex order handling systems to recognize that a parent institutional order exceeds a size of 50 board lots or $100,000 value, while being handled by an algorithm for scheduled execution, a smart router, or another component, are very complex. Such changes would require all systems to take into account both the size of an order and an additional size of a parent order. Changes on this scale would require significant development work at all stages of the order handling process, and we estimate would require far more than the indicated 90 days of implementation time.

Additionally, a Canadian dealer's southbound order routing system would require the ability to specify different limit prices for orders routed to the U.S. markets – a price eligible for execution on lit markets only, and a price eligible for trading on dark markets. This change would require systems modifications among U.S. executing brokers currently serving the Canadian dealer community's southbound needs. The ability to specify two distinct limit prices is generally unusual in order handling systems, and we believe such changes for both Canadian dealers and their U.S. executing partners would require comprehensive systems changes, well in excess of the suggested 90 day time frame.

We appreciate the opportunity to comment on this matter.

*Respectfully,*

*"Signed by the CSTA Trading Issues Committee"*

c.c. to:

**Ontario Securities Commission:**
Mr. Howard Wetston, Chair and CEO
Ms. Maureen Jensen, Executive Director & CAO
Ms. Susan Greenglass, Director, Market Regulation
Ms. Tracey Stern, Manager, Market Regulation

**British Columbia Securities Commission:**
Ms. Sandra Jakab, Director, Capital Markets Regulation

**Alberta Securities Commission:**

Ms. Lynn Tsutsumi, Director, Market Regulation

**Autorité des Marchés Financiers:**
Mme. Élaine Lanouette, Directrice des bourses et des OAR

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Ms. Andrew Kriegler, President and CEO
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