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Re: Re-Publication of Proposed Dark Rules Anti-Avoidance Provision

Dear Sirs and Mesdames:

TD Securities welcomes the opportunity to comment on the *Re-Publication of Proposed Dark Rules Anti-Avoidance Provision* (the Proposed Provision).

TD Securities is a leading securities dealer in Canada and the number one ranked block trader in Canadian equities and options based on dollar value and shares traded. TD Securities also acts as the executing dealer for TD Waterhouse, the largest discount brokerage firm in Canada.

TD Securities previously commented on the original publication of the *Provisions Respecting the Execution and Reporting of Certain "Off-Marketplace" Trades* in our letter dated July 13, 2012. In that letter we described several harmful impacts of the Proposed Provision, including:

- Ability to achieve best execution for Canadian investors
- Creation of a two-tier marketplace favouring HFTs and professional traders at the expense of natural Canadian participants
- Inconsistent treatment of dark orders on US visible marketplaces
- Disadvantaged position of Canadian dealers relative to US dealers which will discourage global flows into the Canadian marketplace
- Excessively high transaction costs relative to the US market

Our position on the above has not changed with the re-publication of the Proposed Provision. In addition, IIROC has published revised *Guidance on the Definition of "Foreign Organised Regulated Market"* (FORM) which raises issues closely related to the Proposed Provision. We include comments on the definition of a FORM in this letter.

Best Execution Advantages of the US Market

At TD Securities, we consider "Best Execution" to be our obligation to seek the most advantageous execution terms reasonably available when executing a transaction on behalf of a client, including factors such as:

- Price of execution
- Speed of execution
- Certainty of execution
- Overall cost of the transaction for the client

In the US marketplace, retail brokerage firms have partnered with wholesale dealers (wholesalers) to provide best execution to retail clients. Under these agreements, wholesale dealers stand by to immediately execute marketable retail orders in their entirety (up to a certain maximum size) at or better than the prevailing quote, including orders which may be larger than the displayed quote size. The retail client receives a better price and greater certainty of being filled than executing the order on a visible marketplace, where orders may go unfilled due to quote fade or by attempting to trade more than the displayed size.

The US wholesaling model is similar to the TSX Minimum Guaranteed Fill (MGF) facility, where the TSX Registered Trader (RT) will step up to immediately execute small marketable orders at the prevailing quote to provide liquidity to retail clients. The key differences between the US wholesaling model and the TSX MGF are:

- There is competition among US wholesalers to win business from retail brokerage firms by offering improvements in execution quality. The TSX MGF is assigned to a single RT without competition.

- Price improvement is available from US wholesalers, whereas TSX MGF trades are priced at the quote with no improvement.

- US wholesalers will guarantee execution for orders ranging from 5,000 to 10,000 shares in size, depending on the liquidity of the security. The TSX MGF sizes range from 199 to 2,599 shares, with an average of 640 shares for SPTSX index stocks.

Our internal execution statistics show that over 15% of our marketable Canadian retail orders cannot be satisfied by top-of-book liquidity on Canadian marketplaces. These orders are either partially filled, or displace multiple price levels beyond the initial quote. In the US market these orders would be immediately filled by wholesalers at or better than the prevailing quote with no price impact. Retail investors in the US market have a better execution experience, lower price impact and greater certainty of being filled as a result of the competitive wholesaling model.

The US market is attractive to Canadian retail brokerage firms because of these improvements in execution quality. The Dark Liquidity Rules introduced in October 2012 created structural barriers to offering a similar level of execution quality to Canadian investors. We are concerned that this structural weakness in Canadian execution quality will erode the long term vibrancy and relevance of Canadian equity markets.

In our view, it is critical that Canadian markets be globally competitive and able to attract order flow on their own merits, rather than be supported by protectionist regulations. To achieve this, we feel that the Canadian market model should offer a similar level of execution quality to retail investors as that provided by US wholesalers. This could be accomplished by leveraging the MGF facility to create competition among Registered Traders and increasing the MGF sizes to match US wholesaler equivalents, or by introducing competing MGF facilities on alternative marketplaces, or by modifying the Dark Liquidity Rule to promote retail best execution.

Impact of Dark Liquidity Rules

In June 2011, Alpha Trading Systems launched a dark trading facility (Alpha IntraSpread) designed to compete with US wholesalers by offering retail investors greater certainty of execution and better prices than available on Canadian visible marketplaces. The facility was successful, reaching over 4% market share and paying roughly $7 million in price improvement to retail investors from June 2011 to October 2012, while at the same time achieving lower market impact and larger fill sizes than comparable executions on visible marketplaces.

The Alpha IntraSpread model encouraged competition among liquidity providers by offering open access to marketable retail orders, and provided a minimum guaranteed price improvement of 10 mils over the displayed quote. The model also reduced costs for retail brokerage firms by charging a 4 mil take fee, compared to 25 to 35 mils on visible marketplaces.

Canadian regulators were concerned that unrestricted growth in dark liquidity could impact price discovery in the visible market, and enacted Dark Liquidity Rules in October 2012. The Rules require dark orders to offer a full trading increment of price improvement over the displayed quote (or midpoint in cases where the spread is one increment wide). The Rules eliminated the economics of providing two-sided liquidity in dark markets. As a result, Alpha IntraSpread immediately dropped to 0.5% market share as liquidity was withdrawn.

On March 6, 2015 IIROC published an academic paper entitled *"The Impact of the Dark Trading Rules"* co-authored by Andreas Park and Katya Malinova of the University of Toronto and Carole Comerton-Forde of the University of Melbourne, Australia. The paper is a comprehensive study on the impact of the Dark Trading Rules on market quality based on a dataset of orders, quotes and trades provided by IIROC covering the period from January 1, 2013 through June 30, 2013. The dataset included unique (but masked) identifiers for individual broker and trader IDs, which allowed trading behaviours to be investigated for specific classes of market participants.

The key findings confirm many observations we have made based on our own experience with the quality of retail execution and internal trade flows post the implementation of Dark Liquidity Rules:

- Overall market quality metrics such as price discovery and effective spread were unchanged
- Intraday returns decreased for retail investors as the loss of price improvement increased their market impact costs
- Passive fill rates decreased for institutional investors as their orders became crowded out by HFTs moving into the visible market
- Execution costs increased for retail brokerage firms

In our view, the findings understate the harm done to retail investors by not considering the opportunity cost of unfilled marketable orders. We have seen fill rates decrease for retail investors as liquidity was withdrawn from Alpha IntraSpread, reducing the certainty of execution for marketable retail orders.

The reduction in execution quality for retail investors combined with increased execution costs caused some Canadian retail brokerage firms to consider re-routing their Canadian interlisted orders to US wholesalers to achieve better prices, greater fill certainty and a lower cost of execution than available on Canadian visible markets. This practice has directly led to IIROC publishing revising guidance on the definition of a FORM and re-publishing the Proposed Anti-Avoidance Rule in an effort to restrict access to the US market.

In our view, the *"Impact of Dark Trading Rules"* paper presents strong evidence that the Dark Liquidity Rules have harmed natural market participants and these Rules should be re-evaluated to improve execution quality in the Canadian marketplace. We prefer to see the root cause of the problem addressed rather than introducing regulation which attempts to protect the Canadian market from foreign competition by erecting barriers to the US market.

Definition of a Foreign Organised Regulated Market

On December 15, 2014, IIROC published *Guidance on the Definition of "Foreign Organised Regulated Market"* which clarified IIROC's position on US trade reporting facilities.

UMIR defines a FORM as a market outside of Canada:

> *"(a) that is an exchange, quotation or trade reporting system, alternative trading system or similar facility recognized by or registered with a securities regulatory authority that is an ordinary member of the International Organization of Securities Commissions;*
>
> *(b) on which the entry of orders and the execution or reporting of trades is monitored for compliance with regulatory requirements at the time of entry and execution or reporting by a self regulatory organization recognized by the securities regulatory authority or by the market if the market has been empowered by the securities regulatory authority to monitor the entry of orders and the execution or reporting of trades on that market for compliance with regulatory requirements; and*
>
> *(c) that displays and provides timely information to information vendors, information processors or persons providing similar functions respecting the dissemination of data to market participants for that market of at least the price, volume and security identifier of each trade at the time of execution or reporting of the trade on that market,*
>
> *but, for greater certainty, does not include a facility of a market to which trades executed over-the-counter are reported unless:*
>
> *(d) the trade is required to be reported and is reported to the market forthwith following execution;*
>
> *(e) at the time of the report, the trade is monitored for compliance with securities regulatory requirements; and*

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(f) at the time of the report, timely information respecting the trade is provided to information vendors, information processors or persons"

From our interpretation of the new guidance, the FINRA Trade Reporting Facility (TRF), OTC Reporting Facility (ORF) and Alternative Display Facility (ADF) are not considered to be Foreign Organised Regulated Markets, and a Canadian dealer cannot route orders to a US broker-dealer if the trades are executed on these trade reporting facilities.

The guidance was specifically published to prevent Canadian retail brokerage firms from entering arrangements with US wholesale dealers and executing Canadian interlisted orders in the US market.

"If a U.S. broker-dealer reports a trade that it has internally matched to a trade reporting facility such as the OTC Reporting Facility ("ORF"), the trade reporting facility alone does not meet the definition of FORM since it is not a recognized or registered market pursuant to section (a) of the FORM definition."

We question this interpretation of section (a). The FINRA TRF, ORF and ADF are trade reporting facilities provided by FINRA and recognised by the SEC, a securities regulatory authority which is an ordinary member of IOSCO. Trades on all three facilities are reported to and publically disseminated by the Securities Information Processor (SIP). If these three FINRA trade reporting systems do not meet the definition of a FORM pursuant to section (a), being a:

".. quotation or trade reporting system.. recognised or registered by registered with a securities regulatory authority that is an ordinary member of the International Organization of Securities Commissions"

then we suggest the definition be modified to strike *"trade reporting system"*, as we can think of no trade reporting facility that could possibly qualify.

This guidance significantly impacts long-standing business practices and access to US markets by Canadian dealers. Roughly 28%[1] of US trade activity is printed directly to the FINRA trade reporting facilities rather than being executed on a US exchange or ATS. The FINRA trade reporting facilities act as cross reporting facilities for US dealers, in a similar way as Canadian dealers may print crosses on Canadian marketplaces. These trades represent block crosses in the upstairs market, broker-to-broker trades, early and late prints, average price crosses and derivative hedges, in addition to retail executions by wholesale dealers. The revision in guidance uniformly prevents Canadian dealers from participating in this entire segment of the US market.

Retail investors are specifically harmed by this guidance, as it prevents Canadian dealers from achieving best execution on US orders. In many cases a US wholesale dealer can provide a superior trading experience by offering greater certainty of execution and a better price than available on a visible market. A Canadian retail investor trading in a US dollar account, or self-directing their order to the US market, expects the best possible US execution. The guidance places Canadian investors at a disadvantage relative to their US neighbours by prohibiting access to the best priced and most certain liquidity in the US market.

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[1] Bloomberg: TRF (not disclosed) 28.19% of Total Market Volume, February 2015

Proposed Dark Rules Anti-Avoidance Provision

Our views on the Proposed Provision have not changed since its original publication on April 13, 2012. The Proposed Provision will harm best execution of client orders by prohibiting access to a significant proportion of liquidity in the US market.

IIROC is of the view that *"price improvement of anything less than what would constitute a "better price" is not sufficiently meaningful to deny the Canadian market the benefit of transparency".* We are concerned that denying small-sized orders the opportunity to seek best price has the effect of subsidizing certain market participants by disadvantaging retail clients. We prefer to see trading economics governed by the free hand of the market, rather than through regulations which tax retail investors to artificially support liquidity providers.

The IIROC view also minimizes the importance of certainty of execution. In a case where a marketable order cannot be satisfied by top-of-book liquidity on Canadian marketplaces, an executing dealer may face the following choices:

- A partial fill in the Canadian market, with exposure to price impact or opportunity cost on the unfilled balance
- A complete fill in the US dark market, at a better price than the initial top-of-book Canadian quote

Clearly the second choice represents best execution for a retail or institutional investor, a choice which will not be available with the implementation of the Proposed Provision.

The Proposed Provision places Canadian investors at a disadvantage by requiring small size orders to trade at worse prices than available in the US dark market. Canadian orders would be "fish in a barrel" to an interlisted arbitrage trader, and could be directly scalped against the better US prices. We feel it is unfair to create a regulatory structure which locks in low risk profits for an intermediary at the expense of natural Canadian participants.

The Proposed Provision clarifies that dark orders resting on a US exchange will be exempt from the Anti-Avoidance provision. We view this treatment as biased in favour of exchanges, which may offer similar dark trading facilities as a fully dark ATS but without the corresponding restrictions. The alternative of applying the Anti-Avoidance provision to dark orders on US exchanges is not a workable solution either, and highlights a logical inconsistency of the Proposed Provision.

The Proposed Provision does not consider the impact on inbound global flows to the Canadian market. Erecting a barrier to the US market both keeps Canadian flow in Canada and US flow out. It will be exceptionally difficult to attract global order flow to Canadian markets if Canadian dealers have only partial access to North American liquidity while US dealers have full access to all marketplaces, visible and dark. We expect the majority of northbound order flow to be redirected to US dealers if the Provision is implemented.

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?*

We consider the most effective approach to achieve the policy objective of maintaining the quality of Canadian price discovery and competitiveness of our equity markets is to re-evaluate the Dark Liquidity Rule, which has harmed execution quality for natural participants and weakened the competitive position of Canadian markets.

As a potential modification, we suggest the definition of "better price" be aligned with the notional value and risk of a trade to close the gap in execution quality between Canadian and US markets.

The current requirement for one cent of price improvement on securities priced over $1 (or midpoint in cases where the spread is one cent wide) is a blunt increment that does not scale to the value of a trade. If one cent is considered meaningful on a $30 security, then ten mils should similarly be considered meaningful on a $3 security to provide a consistent relative level of price improvement.

The competitive advantage of the US market is greatest in low-price securities where the one cent increment is a significant barrier to Canadian liquidity providers, and make/take rebates are high relative to the value of a trade. We suggest redefining "better price" as one cent (or midpoint) for orders priced at or above $10 and ten mils for orders priced under $10. This scaling would appropriately align price improvement to the risk and notional value of a trade, narrow the gap in price improvement between US and Canadian markets for the most critical low-price securities, and improve Canadian execution quality by encouraging two-sided liquidity provision in Canadian dark marketplaces.

We also recommend the creation of trading facilities to allow liquidity providers to compete for retail order flow. These could take the form of an extended Minimum Guaranteed Fill facility with competing Registered Traders and higher MGF sizes, or competing MGF facilities at alternative marketplaces. Competition among liquidity providers for retail orders will improve Canadian execution quality in terms of price and certainty of execution, and reduce the relative best execution advantages offered by US wholesalers.

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?*

Yes, US dollar accounts are distinct from other client accounts and should be permitted to trade in the US market without reference to CBBO, and with an exemption to the revised definition of a FORM. Orders which are directed by clients to US marketplaces should be treated in the same manner as those originating from US dollar accounts. In both cases the client is trading a US symbol with reference to a US displayed quote, and is expecting the best possible execution in the US market. Redirecting these orders to the Canadian market would incur additional costs in ticketing, clearing and foreign exchange, and fail to achieve best execution for the client. We do not foresee this exemption being exploited contrary to the principles of the Order Exposure Rule.

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?*

The modification of cross-border order routing and algorithmic trading systems to accommodate the Proposed Provision is significant and cannot be accomplished in 90 days. In many cases a Canadian dealer may outsource these systems to third party providers, and would be dependent on a vendor or US broker-dealer to prioritize the development effort. If the system changes could not be made by the implementation date then the Canadian dealer would need to block access to US markets to remain compliant.

We also note that the development effort to accommodate the Proposed Provision will displace resources from business initiatives aimed to improve client services and enhance Canadian market access.

We appreciate the opportunity to comment on the Proposed Provision, and we would welcome a meeting with IIROC or CSA Staff to further discuss our views.

Respectfully,

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