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RE: IIROC Rules Notice and Request for Comments,
15-0023 Re-Publication of Proposed Dark Rules Anti-Avoidance Provision

Dear Mesdames and Sirs,

We write today on behalf of RBC Dominion Securities Inc. ("RBCDS") in response to the above noted request for comment. RBCDS welcomes the opportunity to provide comment on the issues raised therein.

The challenge facing Canadian equity markets presumed in this request for comment is the risk of loss of Canada's retail order flow to U.S. internalizers based on regulatory arbitrage. While the scope of this problem is perhaps somewhat overstated, it nevertheless needs to be taken seriously. The bedrock of any robust equity market is the diversity of its participants – with investors (retail and institutional) and intermediaries all playing a role. Specifically, it is clear that healthy retail participation is a key ingredient to robust equity markets.

Nevertheless, we must balance the above with the imperative to maintain principles core to the operation of our equity markets and the diversity of the order flow that they attract against the risk of unintended consequence through regulatory action. This must take into account the need to ensure our equity markets (and perceptions thereof) remain fair and competitive.

At the outset it should be stated that the Canadian equity market's relationship with the U.S. is incredibly complicated for a host of reasons. We share many listings – inclusive of many of the names in our benchmark equity index. Our markets trade at the same hours of the day and are highly integrated. On the other hand, Canada's markets are relatively small and concentrated in nature compared to the U.S.

As a result of the latter, practices have evolved in the U.S. that most agree would be unsustainable in a Canadian context. Canadian regulators have, in this regard, generally done a good job of balancing this cross-jurisdictional integration and complexity while retaining the important and unique aspects of Canada's equity markets. Yet, today we are at a dangerous crossroads facing a decision key to maintaining the health of our markets – both for purposes of listings as well as for attracting flow from a diverse set of investors and intermediaries. In this context we must carefully consider all potential paths to the stated policy objectives.

Cream Skimming of Retail Flow

Various academic studies have examined the problem of cream-skimming – so called because of the phenomena of desirable flow being "skimmed" from a lit market (generally internalized or sold) leaving relatively less attractive flow. This can be a serious problem as it increases the proportional toxicity of all remaining order flow. In general, academics agree that excessive extraction of desirable flow from markets is bad from a market quality perspective. Speaking broadly, the only flow that is almost ever “skimmed” is retail.

The attractiveness of retail orders are obvious as they generally share the following desirable characteristics:

- *small* – most often being less than 500 shares;
- *marketable* – meaning either designated market orders or marketable limit orders that are priced well into the contra-side NBBO;
- *bi-directional* – meaning consisting of both buy and sell orders;
- *plentiful* – meaning many orders (again small, marketable and bi-directional).

Unlike the orders of intermediaries or institutional investors, retail investors tend to trade more often for reasons dictated by their own circumstances – and not based on unique fair value insight to particular stocks or preferred access to the marketplace. On the other hand, institutional investors, hedge funds and intermediaries generally have unique insight (stemming from their alpha models, or investment in trading technology) and typically make use of larger recurring directional orders which makes their flow (particularly active flow) less desirable to interact with (i.e. more informed).

Unintended Consequence

While well intended, we believe that the proposed rule changes constitute a blunt tool. We appreciate the desire of regulators to avoid defining or specifically policing retail flow through rule making. Nevertheless, due to retail's specific attractiveness, this poses a challenge. Ultimately the rule changes as proposed could have a number of undesirable consequences - among them:

1. **Foisting unnecessary regulatory intervention and cost on Canadian dealers competing to service institutional orders:** As proposed, the rules would burden these businesses with another rule for which no policy objective can be articulated relating to the businesses in question. This would necessitate a variety of costly code and infrastructure changes in order to cope with the relatively small portion of institutional orders that would fall under the rule (i.e. orders on the institutional platform where the “parent” order is for less than 50 Standard Trading Units and/or less than $100,000). Notably, the proposed carve out for larger orders would do nothing to relieve dealers of the need to make changes to their infrastructure.

2. **Placing Canadian dealers generally at an ongoing disadvantage relative to those in other jurisdictions:**
   - they would face a uniformly higher cost structure;
   - less options would be available to Canadian dealers (in particular those focused on serving institutions) as to how order flow is handled;
   - being at a disadvantage, they may be less likely to invest in infrastructure or innovation - again, undermining competitiveness on the world stage;
   - could be generally negative for Canada's small boutique dealers – undermining the diversity and competitiveness of the domestic dealer community.

3. **Retaining domestic retail flow could come at the cost of retail flow from other jurisdictions:** As outlined above, the rules would put Canadian dealers at a disadvantage. The result being that routing decisions would stay in other jurisdictions and such flow’s attraction to Canadian equity markets might either be significantly curtailed or, in some cases, eliminated altogether. Reducing the diversity of retail flow emanating from non-Canadian sources could in turn reduce the attractiveness of Canada as a trading destination.

4. **Risk of perceived protectionist stance on the part of Canada’s regulators:** While we certainly understand that the objective here is to maintain principles necessary to maintain the health and integrity of Canada’s equity markets, perceptions from south of the border, and indeed globally, may vary.

5. **Incremental Rule-Making:** It is concerning that the trajectory of the proposed rule would layer rule upon rule rather than recognizing the externalities that have been created by previous rule-making. We are of the view that this type of rule making should almost always be avoided in favor of fostering an environment where innovation and commercial solutions can flourish.

Overall, we see a number of potentially negative consequences to the planned approach – quite possibly counterbalancing any benefit realized. The relative attractiveness of retail flow when combined with the lack of the ability of Canada's regulators to enforce principles on flow emanating from outside their jurisdiction makes this challenging.

Recommendations

Thus far, we remain unconvinced that the introduction of a new rule is yet justified – and believe doing so risks causing as many problems as it solves. Canada's regulators continue to have other tools at their disposal to achieve the stated policy objectives. In particular, morale and reputational suasion are powerful ones that should not be underestimated.

The recent guidance on the definition of a Foreign Organized Regulated Market ("FORM") is seemingly helpful in limiting the potential destinations that southbound flow could interact with. That said, we would caution that there may yet be ways for inventive U.S. operators (outside of IIROC's power to regulate) to cater a technical bypass to this definition. As such, caution and vigilance is warranted.

Regulators should seek to foster commercial solutions wherever possible. Both TMX Group and Aequitas have advanced solutions that aim to offer cost relief for retail networks. In the case of the former, we have not been supportive of the solution offered to date but remain hopeful that TMX will find ways to assist all Canadian dealers in a more balanced fashion. The solutions offered by Aequitas are just now coming to market and we remain both supportive and enthusiastic that Aequitas can assist dealers and, in so doing, retain retail flow in Canada in a more natural fashion.

In addition to the above, regulators have existing authorities which could yet prove effective – without the need for incremental new rule making. We would suggest that targeted trade desk reviews could well provide a more flexible way of ensuring that retail flow is not indiscriminately packaged and sold to U.S. internalizers. Again, the goal here should be to avoid being too prescriptive but likewise enforce the message that:

- achieving best execution involves managing multiple tradeoffs, something that bulk indiscriminate order flow shipment is inconsistent with;
- de minimis price improvement is not considered a material best-ex win and will receive little weight against other considerations including speed, certainty, size of the NBBO versus size of the order, etc.;
- the definition of FORM should be coupled with a current and ongoing understanding of all destinations that a retail network is interacting with and how these fit into solving for best-ex for their clients; and
- receipt of rebates or cost avoidance and the weight it receives should be carefully monitored for – in particular to the extent that it appears to be having an undue influence on overall best-ex obligations.

It should also be clear that all Canadian retail networks hold certain responsibilities to the general health, vitality and integrity of our equity market. This responsibility should not be seen as at odds with fair and open competition with international equity markets. On the other hand, it should be inclusive of upholding the spirit of the rules and principles in which we operate in Canada. It should also be informed by an understanding of the complex relationship we have with the U.S. While the dark rules remain in place, we would be of the view that these form an integral part of this balancing act.

The Dark Rules

In our view The Dark Rules introduced in October 2012, while well-intended, have contributed to the challenges we find ourselves facing today. We continue to be sympathetic to the objective of preventing growth in dark to problematic levels – yet we have expressed concern that that the approach now in place may be too extreme. Specifically, today's price improvement requirement of full tick or 1/2 tick for single tick spreads is disproportional to the common single mil price improvement often occurring in the U.S. In offering comment historically it was our view that allowing 10% of the spread to serve as the minimum amount considered to be material (as offered by Alpha Intraspread at the time) was a reasonable starting point absent a specific problem.

Unfortunately, we believe the extreme economic differentials between trade-at regimes in Canada and the United States has emerged as a meaningful motivator for retail trade flow migration. Specifically, it is important to highlight that we make this statement within the context of understanding that where trades are executed is a complex function not just of a client and their orders or of their agent's economics and best execution obligations but of all parties involved including the economics of trading venues, economics and risk preferences of would-be counterparties, etc.

It should be noted that Canada's distinct regulatory approach in relation to the United States extends well beyond price improvement requirements. We maintain strict fair access rules for all trading facilities, restrict the ability of brokers to establish systems that have all the markings of a matching facility without offering fair access to such facilities, limit payment for access to order flow to marketplaces, and enforce, with limited exception, immediate exposure of smaller orders to lit markets unless they are given material price improvement. On this basis, as it relates to "dark" Canada has an otherwise decidedly different context when compared to the U.S. Specifically, we do not believe that dark trades occurring under the aforementioned regime gives rise to the same concerns they do in the U.S.

That said, we continue to support the above principles and the current dark rule regime – with the caveat that we would encourage regulators to consider relaxing the benchmark for meaningful price improvement. Indeed, it cannot be denied that if the pre-dark rules incarnation of Alpha Intraspread were available today, such a facility would likely be a viable Canadian commercial answer to much of today's challenges. And, through our fair access rules, said solution would allow all participants access to this flow – in Canada.

With regard 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?*

   U.S. dollar denominated accounts are distinct and should not be subject to the proposed rule. Compelling such accounts to route orders to Canada would be compelling them to pay the associated f/x spread. The choice to denominate an account in U.S. Dollars is that of the retail client – a decision they make for individual reasons.

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?*

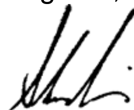
   We believe there would be substantial development work required for participants, their U.S. affiliates and/or execution providers to comply with this rule. As such, at minimum a 6-month implementation window would be required.

To summarize, while we understand the policy objectives that the proposed rules are aiming to solve, we believe such a rule is not justified. Ultimately, were it to be necessary, given the particular risk and externalities we have discussed we would favor it applying solely to retail operations. That said, we believe that morale suasion, guidance, and trade-desk reviews focused on principles of best execution are a more appropriate tool for regulators to leverage at this time. As indicated, we believe the rule as proposed will have several serious unintended consequences and very likely cause as many, if not more problems than it solves.

We encourage IIROC to separately consider moderating the definition of meaningful price improvement in the Dark Rules to moderate the economic differential between the U.S. and Canada. We believe this would open the door to innovation and natural commercial solutions – almost surely the most resilient and sustainable way to address the problem at hand while keeping Canada competitive.

Should you require further clarification please contact the undersigned.

Regards,



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