



CANADIAN SECURITY TRADERS ASSOCIATION, INC.

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May 31, 2019

The Secretary
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and

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Re: Joint CSA/IIROC Consultation Paper 23-406 – Internalization within the Canadian Equity Market

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 four distinct regions (Toronto, Montreal, Prairies 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", "CSTA TIC" 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.

The Canadian Security Traders Association appreciates the opportunity to comment on the complex and multi-faceted topic of order flow internalization within the Canadian equity market. The issues at play are fundamental, far-reaching and strike to the core principles behind Canadian capital markets.

This submission is the result of numerous discussions among Trading Issues Committee members. As an industry group, the CSTA is unable to achieve a consensus opinion on all the issues at question. Rather than attempt to provide a solutions-oriented response, we present the general views of institutional participants, including the competing views at play where appropriate.

The Tragedy of the Commons

A common perception among institutional participants is that the issue of internalization is linked to the concept of the "tragedy of the commons," where the good of the whole is compromised by the profit-seeking motive of individuals. In the context of order flow internalization, there are three types of profit seeking entities that are viewed to be advantaged: the dealers who internalize flow, the retail execution desks whose orders are being intermediated and the retail investors themselves. The concern of our group is that these entities will continue to seek to maximize their commercial interests, even if seeking to do so is at the expense of the public good and of the overall market. In the case of the Canadian equity markets, one facet of the public good can be the collective ability to effect transactions in equities with minimal frictional costs, including counterparty search costs.

We note that commercial solutions and individual actions are not likely sufficient for achieving a balanced outcome. The duty owed by all participants is to their clients or their firm rather than to the market as a whole. This means that any reduction of economic results (either through worse execution for clients or worse financial outcomes for the firm) from actions which favor the interest of the market are likely inappropriate under a best execution or fiduciary duty to investors standard. As a result, many participants believe that balancing the common good against the individual good is the place of regulation rather than commercial solutions.

Institutional participants are particularly concerned with the potential hollowing out of the majority of natural investor activity – particularly small retail investor activity – from the multilateral market. As small natural retail client order flow is internalized by a select few participants, the remaining participants (primarily large institutional investors with significant information leakage concerns, and their executing dealers) may be exposed to an illiquid and more toxic trading environment.

We note that the concern over liquidity effects from order flow internalization is limited primarily to activities involving small retail order flow. While large block trading could also be considered order flow internalization, it is not generally seen as being detrimental to market quality since its primary use is to allow large pooled groups of retail investors (i.e. institutional investors) to execute orders that would otherwise involve material frictional costs and could not otherwise be executed near to or at current market prices. Broker block facilitation activities are also considered beneficial since they tend to involve offsetting large directional client orders with significant information content and a high degree of risk.

We believe that a regulatory initiative aimed at balancing common and individual good must take into account the key dimensions of best execution duties owed to clients and the fiduciary responsibilities of asset managers to their unitholders. Any regulatory action which aims to improve the common outcome must simultaneously address concerns over potential compromises of either fiduciary duties to unitholders or best execution duties to clients.

Some participants have expressed the view that achieving the aims of the common good is not entirely inconsistent with the goals of best execution. For instance, best execution guidelines could be amended to encourage participants faced with equal alternatives to choose the alternative that is seen as more supportive of the common good. However, the details of any such guidance must be carefully considered including all dimensions of best execution – most importantly, information leakage.

Any changes to the best execution regime which aims to support the common good will raise questions of whether dealers' choices in the "common good" conflict with the client's fiduciary interests. We believe that amendments to best execution standards to favor the common good will require clear guidance to both dealers and clients, which may take the form of some type of "obligation to the marketplace" similar to the "best price" obligation before the introduction of the Order Protection Rule.

Broker Preferencing

Several participants view the practice of broker preferencing as a practical compromise between the interests of dealers in allowing their sources of flow to interact, and the interest of the market in allowing a diversity of participants to trade with each other. In this regard, broker preferencing is a somewhat unique Canadian compromise that has served to maintain balance.

Historically, broker preferencing was used by brokers as a tool to assist in the unwinding of risk. With recent technological advances and competitive pressures, dealer workflows that systematically leverage broker preferencing have been developed. These workflows can be controversial, and in the views of some, can violate the very spirit of broker preferencing. The concern arises from the belief that orders which receive the benefits of broker preferencing should be those which are also generally accessible to the market at large. As a result, some adjustment to the mechanism of broker preferencing in the market may be appropriate.

While we are not advocating for any specific measure, we believe that specific actions could be taken to the extent that current broker preferencing practices are seen as damaging to the market. Some possible adjustments, which would require refinement based on industry discussion, include:

- A "minimum life" provision across all marketplaces by which only orders that have been present in the book for a certain length of time may receive broker priority;
- Adjustments to the practice of anonymous broker preferencing in undisplayed "dark" markets;
- Restriction of broker priority to orders from "natural" participants rather than intermediaries, or "client" as opposed to "inventory" orders.

Importantly, to the extent that a restriction on broker preferencing is seen as appropriate, the change cannot come from commercial solutions by a marketplace. Any marketplace which reduces the benefits offered through broker preferencing will penalize its users, who will migrate flow to marketplaces which have not made similar changes. As a result, the "first mover" attempting to rebalance the benefits and costs through their own action will be commercially penalized, without an improvement to the common outcome.

Segmentation

The most contentious aspect of the discussion of internalization is the degree to which internalization should be permitted on specific, targeted segments of the market. The practice of retail segmentation raises several concerns among institutional participants:

- Retail order flow is a significant contributor to price discovery, and its removal (through internalization practices) would compromise the activities of participants reliant on effective price discovery;
- Increased segmentation of retail flow is likely to increase order flow toxicity among the remaining non-retail market, driving volume away from the displayed markets;
- The reduction of the breadth of participation in the open market resulting from retail segmentation will result in greater information leakage for institutional investors.

More generally, the segmentation of retail flow creates a two-tiered market. We question whether the practice of order flow segmentation is consistent with the principles of fair access to the marketplace. The CSTA has historically opposed the practice of segmentation, including in our public comments to various marketplace proposals involving guaranteed-fill facilities for retail orders. We reiterate our historical view that the segmentation of retail flow away from the broader market will be damaging to the average Canadian individual which invests in pooled investment products via institutional asset managers or has a significant portion of their economic wealth managed by pension plans, both of which are considered institutional investors.

Order Routing

Finally, we note that in today's trading environment, marketplaces compete largely through variations on trading fees – including inverted fees. Inverted fees exacerbate concerns around segmentation since structural differences in routing practices can effectively dictate fill priority for various types of clients. The competition for fees is closely linked with the practice of retail flow segmentation. To the extent that segmentation is seen as damaging to market quality, we believe it is equally appropriate to examine the effect of various routing practices and fee structures as potential contributors to the erosion of market quality.

These issues are intertwined with the difficulties that investors face in assessing order routing practices by brokers. Canada currently lacks a standardized framework for order handling disclosures, such as the SEC Rule 606, which was recently updated in 2018. Some of our Committee members believe that standardized and mandated broker order handling disclosures would assist institutional investors in making informed decisions when selecting executing brokers and when determining if their best interests are being prioritized.

Respectfully,

“Signed by the CSTA Trading Issues Committee”

c.c. to:

Ontario Securities Commission:

Ms. Maureen Jensen, Chair and CEO
Ms. Leslie Byberg, Executive Director & CAO
Ms. Susan Greenglass, Director, Market Regulation
Ms. Tracey Stern, Manager, Market Regulation

Alberta Securities Commission:

Ms. Lynn Tsutsumi, Director, Market Regulation

Autorité des marchés financiers:

M^e Anne-Marie Beaudoin, Secrétaire générale

British Columbia Securities Commission:

Ms. Sandra Jakab, Director, Capital Markets Regulation

IIROC:

Mr. Andrew Kriegler, President and CEO
Ms. Victoria Pinnington, Senior Vice President, Market Regulation
Mr. Kevin McCoy, Vice President, Market Regulation Policy