

April 30, 2019

BY EMAIL

British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumer Services Commission, New Brunswick
Superintendent of Securities, Government of Prince Edward Island
Nova Scotia Securities Commission
Superintendent of Securities, Department of Service NL, Provincial Government of
Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon
Superintendent of Securities, Department of Justice, Government of Nunavut

The Secretary
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Toronto, Ontario M5H 3S8
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M^e Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, rue du Square Victoria, 22^e étage
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Montréal (Québec) H4Z 1G3
Email: consultation-en-cours@lautorite.qc.ca

Dear Sirs/Mesdames:

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

The Canadian Advocacy Council¹ for Canadian CFA Institute² Societies (the CAC) appreciates the opportunity to provide general comments on the Consultation Paper and respond to certain of the specific questions outlined below.

As a general comment, we are supportive of the collaborative consultation process undertaken with respect to the Consultation Paper; both with respect to the cooperation

¹ The CAC is an advocacy council for CFA Societies Canada, representing over 17,000 Canadian charterholders, of the 12 Member Societies across Canada. The council includes investment professionals across Canada who review regulatory, legislative, and standard setting developments affecting investors, investment professionals, and the capital markets in Canada. Visit www.cfacanada.org to access the advocacy work of the CAC.

²CFA Institute is a global, not-for-profit professional association of over 166,000 investment analysts, advisers, portfolio managers, and other investment professionals in 163 markets, of whom more than 159,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 152 member societies in 74 markets. For more information, visit www.cfainstitute.org.

between the CSA and IROC but also with respect to the industry meetings and input received prior to publication. The Consultation Paper thoroughly describes the factors that inform the discussion on internalization and looks at the issue from different market perspectives.

We agree that it is an important time to hold discussions and seek input on the impact of internalization. Our main concern is that while the marketplace data shows that the amount and volume of trades may be on the lower end, these numbers may increase over time, resulting in a proliferation of internalized trades over time. Such proliferation would result in the segmentation of retail orders and arguably less price discovery for the market as a whole.

The internalization of retail orders on a marketplace is primarily facilitated through the use of the broker preferencing mechanism (price-broker-time priority). Broker preferencing is a violation of time priority and without time priority there is a disincentive for others to display liquidity on a marketplace. Effectively, broker preferencing enables queue jumping and queue jumping facilitates the internalization of retail orders by allowing the broker to passively take the opposite side of a retail trade and to earn the bid/ask spread.

The CAC believes that the above internalization concerns are valid. The CAC also believes that the alternative to a broker preferencing regime is a much worse outcome for all investors. An outright ban on retail internalization via the broker preferencing mechanism would likely create an economic incentive for each broker to set up their own trading venue to better access, and to trade against, their own order flow. Currently, investors are witnessing such a scenario unfold in Europe with the proliferation of bank owned systematic internalizers. The European systematic internalizer regime is overly complex and fragmented, especially when compared to the Canadian regime. We would also not support any shift towards a U.S. style wholesaling regime in Canada.

The CAC is generally supportive of the status quo, perhaps subject to a few reasonable limitations, to help dis-incentivize any future proliferation of the current internalization practices. For each broker, once the level of client-inventory unintentional crosses breaches a given threshold, regulators should require the executing broker to demonstrate that their order handling procedures prioritize the best interests of the market as a whole first, followed by the best interests of the client, followed by the best interest of the broker. In addition, upon reaching the threshold, no principal trading should be allowed to trade against client orders via unintentional crosses (i.e., only allow agency trading). Importantly, the burden of proof for such an order handling review should be placed on the broker.

We wish to reply to the specific questions raised in the Consultation Paper as set out below.

Question 1: How do you define internalization?

We agree with the definition in the Consultation Paper; internalization occurs when the same broker is on both sides of a trade, and can be either an intentional or unintentional cross with the dealer acting as agent or principal.

Question 2: Are all of these attributes relevant considerations from a regulatory policy perspective? If not, please identify those which are not relevant, and why.

Yes, we are of the view that the listed attributes are relevant considerations from a regulatory policy perspective.

Question 4: Please provide your thoughts on the question of the common versus the individual good in the context of internalization and best execution.

The internalization discussion is an example of the economic theory of the “tragedy of the commons” where the best interest of the individual conflicts with the best interest of the broader market or the common good. The tragedy of the commons is a term used to describe a system where individual users acting independently according to their own self-interest behave contrary to the common good of all users.

Price discovery and overall market quality ought to be a public good. Everyone benefits from an efficient market. When analyzing the cost/benefits of internalization, it is important for regulators to balance the conflicting interests of brokers vs. the common good owed to the market and price discovery generally. A broker dealer executing a retail order on a client-principal basis through broker preferencing may not be disadvantaging their client, but the broker is certainly acting in their own best interest by providing liquidity via broker preferencing when that retail order would otherwise have been satisfied by an order with higher time priority.

Question 7: Please provide your views on the benefits and/or drawbacks of broker preferencing?

We agree with the sentiments expressed by some market participants and summarized previously by the CSA in the CSA/IIROC Joint Staff Notice 23-308 – Update on Forum to Discuss CSA/IIROC Joint Consultation Paper 23-404 “*Dark Pools, Dark Orders and Other Developments in Market Structure in Canada and Next Steps*” (the “**Staff Notice**”).³ The CSA/IIROC acknowledged that broker preferencing is a

³ Canadian Securities Administrators/ Investment Industry Regulatory Organization of Canada Joint Staff Notice 23-308, “Update on Forum to Discuss CSA/IIROC Joint Consultation Paper 23-404 “*Dark Pools, Dark Orders and Other Developments in Market Structure in Canada and Next Steps*”, (2010) 33 OSCB 4747, online: https://www.osc.gov.on.ca/documents/en/Securities-Category2/csa_20100528_23-308_update-dark-pools.pdf

unique feature of Canadian marketplaces that results from UMIR since dealers must expose small orders on a transparent marketplace. As set out in the notice:

“We acknowledge that broker preferencing is a unique feature of certain Canadian marketplaces and that it is a by-product of Rule 6.3 of the UMIR that requires dealers to immediately expose “small” orders on a transparent marketplace. This rule supports price discovery and increases the breadth and depth of the displayed market and provides direction to achieve best execution for these small orders. In other jurisdictions, these types of orders are often withheld from the market and matched internally by the dealer, therefore eliminating the need for broker preferencing. We agree that the impact of the internalization of order flow is an important consideration in our review of the issues raised at the forum, including broker preferencing.”

The Staff Notice indicated that a common concern was that a lack of broker preferencing might result in dark pools being established by dealers to internalize orders, thereby reducing transparency, and we concur with this concern. The Canadian market has seen significantly less fragmentation of liquidity across trading venues than the U.S. The dark rules, combined with the reasonable use of broker preferencing, facilitated such a regime. It can be argued that the purpose of a market is to bring investors together and to discover price, and thus excessive fragmentation of liquidity across an excessive number of trading venues which pushes investors further apart and increases trading complexity and search costs is not a desirable outcome.

Question 10: Does broker preferencing impact (either positively or negatively) illiquid or thinly-traded equities differently than liquid equities?

Broker preferencing has a larger impact on thinly traded securities and securities with a larger fraction of their trading activity concentrated on the primary marketplace. The value of time priority is large for such thinly traded or concentrated securities.

Question 11: Do you believe that a dealer that internalizes orders on an automated and systematic basis should be captured under the definition of a marketplace in the Marketplace Rules? Why, or why not?

Yes. If the technology used to direct orders to a marketplace is also used to raise the queue priority of an independent contra order from another client or another principal account, on an automated and systematic basis, the technology has moved beyond the scope of a router and is now more similar to the behavior of a marketplace.

Question 12: Do you believe segmentation of orders is a concern? Why, or why not? Do your views differ between order segmentation that is achieved by a dealer internalizing its own orders and order segmentation that is facilitated by marketplaces?

Any such internalization should be compliant with section 8.1 of UMIR, which in general terms only permits a small order to execute against a principal order at a better price. As noted in the Consultation Paper, there is currently a moderate amount of

unintentional crosses in the market (12-13%), and those numbers may grow in the future. Participants in those trades should be required to demonstrate that their order handling practices applicable to retail orders are in fact guided by best execution principles that prioritize the interests of the client ahead of the of the executing broker. Brokers could potentially be required to obtain price improvement in these circumstances, or otherwise demonstrate they are giving precedence to client interests.

Concluding Remarks

We thank you for the opportunity to provide these comments. We would be happy to address any questions you may have and appreciate the time you are taking to consider our points of view. Please feel free to contact us at cac@cfacanada.org on this or any other issue in future.

(Signed) *The Canadian Advocacy Council for
Canadian CFA Institute Societies*

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