

Chapter 13

SROs, Marketplaces and Clearing Agencies

13.2 Marketplaces

13.2.1 Alpha ATS LP – Notice of Completion of Staff Review of Proposed Changes – Intraspread Facility

ALPHA ATS LP NOTICE OF COMPLETION OF STAFF REVIEW OF PROPOSED CHANGES

INTRASPREAD FACILITY

On December 14, 2010 Alpha ATS LP (Alpha) announced proposed changes to its Form 21-101F2 that would result in the implementation of its proposed IntraSpread facility. The IntraSpread facility is a non-transparent book of liquidity designed to offer price improvement and reduced trading fees.

A notice describing the proposed IntraSpread facility was published for comment on December 14, 2010¹ in accordance with OSC Staff Notice 21-703 – *Transparency of the Operations of Stock Exchanges and Alternative Trading Systems*. Five comment letters were received, and a summary of comments and responses prepared by Alpha is included at Appendix A to this notice.

OSC staff have completed their review of the proposed changes and have no further comments. Alpha will publish a notice indicating the intended implementation date.

In the course of OSC staff's review, a number of issues were considered. On certain of these issues, OSC staff believe it is appropriate in this instance to provide some additional commentary for transparency purposes, as follows:

Fair access – Although the IntraSpread facility limits access in some respects in that “Seek Dark Liquidity” orders will be limited to the orders of a “Retail Customer”², OSC staff are of the view that this does not constitute an “unreasonable” limit or condition on access under the fair access provisions in National Instrument 21-101 *Marketplace Operation*³ (NI 21-101).

Internalization – OSC staff acknowledge commenter concerns regarding the potential for IntraSpread to increase the level of internalization of order flow through the inclusion of broker preferencing in its order matching methodology. Alpha has agreed to provide reporting to OSC staff with respect to trading activity within IntraSpread, which will be used by OSC staff to help monitor its impact. Additionally, OSC staff will be conducting a broader review of the concepts of internalization and broker preferencing, and their impact on the markets as a whole.

Consistency with principles outlined in “Dark Liquidity Paper” – OSC staff note that the IntraSpread facility might not be wholly consistent with the principles outlined in Joint Canadian Securities Administrators (CSA)/Investment Industry Regulatory Organization of Canada (IIROC) Position Paper 23-405 *Dark Liquidity in the Canadian Market*⁴, for example with respect to what constitutes meaningful price improvement. CSA and IIROC staff are reviewing the comments received to that paper, and if rule changes are implemented that are consistent with the principles outlined in the paper, revisions to the IntraSpread model may be necessary.

Post-trade transparency – It is OSC staff's view that the IntraSpread facility is akin to a separate and distinct marketplace that would otherwise be subject to the post-trade transparency requirements set out in Part 7 of NI 21-101. Alpha will add a marker to its public data feed that will identify IntraSpread trades. The information processor operated by TSX Inc. (the TMX IP) will also be making amendments to its consolidated data products to distinguish between trades occurring on Alpha's visible market and its IntraSpread facility.

¹ Published at: http://www.osc.gov.on.ca/en/Marketplaces_ats_20101214_rfc-intraspread.htm.

² As defined in the Dealer Member Rules of the Investment Industry Regulatory Organization of Canada.

³ Paragraph 6.13(b) of National Instrument 21-101 states that an ATS shall “not unreasonably prohibit, condition or limit access by a person or company to services offered by it.”

⁴ Published for comment on November 19, 2010 at: http://www.osc.gov.on.ca/documents/en/Securities-Category2/csa_20101119_23-405_dark-liquidity.pdf

IntraSpread trades setting "last sale price" – It is the opinion of IIROC staff that IntraSpread trades would set "last sale price" under IIROC's Universal Market Integrity Rules (UMIR). Alpha requested temporary relief from the requirement for IntraSpread trades to set the "last sale price" under UMIR, which affects UMIR section 3.1 regarding restrictions on short selling and the determination of a "standard trading unit" in accordance with UMIR subsection 1.2(5). IIROC has recommended that temporary relief be granted on the basis that that the impact of IntraSpread trades not establishing last sale price for a short period post-launch is not high and accordingly will have limited consequences. IIROC has recommended that the exemption should expire at the earlier of: (a) December 31, 2011, or (b) 30 days from the end of a month where the aggregate volume executed through the IntraSpread facility exceeds 5% of total market share. Upon the expiry of the temporary relief, Alpha must have implemented the technology changes necessary to enable trades resulting from IntraSpread to set the "last sale price". As the relief sought falls under UMIR section 11.2, approval of the OSC is required. The Ontario Securities Commission has approved IIROC providing the temporary relief subject to the above-noted expiry conditions.

APPENDIX A

ALPHA ATS LP

SUMMARY OF COMMENTS AND RESPONSES TO DECEMBER, 2010 REVISED PROPOSAL ON ALPHA INTRASPREAD™ FACILITY

Background

The Ontario Securities Commission (OSC) published in December (OSC Bulletin Volume 33, Issue 50 (December 17, 2010)), Alpha ATS LP (Alpha)'s notice regarding its revised proposed functionality named Alpha IntraSpread™ Facility (the current proposal)¹.

Alpha Objectives

The objective of the Alpha IntraSpread™ Facility (both the original and current proposal) is to provide choice and options to accommodate different trading strategies and marketplace participants. Some of the strategies that would benefit from using the facility include: enabling the retail flow to participate on the active side and receive a guaranteed price improvement, a larger fill size and a lower active fee; enabling buy side clients to post Dark Orders and benefit from accessing the active flows; and enabling liquidity providers to post Dark Orders to have access to the active flows while providing price improvement.

Comment Process

The OSC and Alpha received 5 comment letters: 2 from dealers², and 3 from other marketplaces³.

Alpha would like to thank all commenters for their submissions. The summary, that follows the discussion of the current proposal, will summarize the key issues and Alpha's responses. Alpha began discussions with the Ontario Securities Commission (OSC) and Investment Industry Regulatory Organization of Canada (IIROC) staff after the closing of the comment period for the original proposal. In response to the comments raised by OSC Staff and further discussions with both OSC and IIROC Staff, Alpha revised its proposal as set out below.

Alpha's Current Proposal

Description of Current Proposal

Alpha published for comment the revised Alpha IntraSpread™ Facility.⁴

The changes addressed the regulatory concerns related to marketplaces facilitating internalization of dealer order flow, while at the same time preserving the benefits of the original IntraSpread™ Facility proposal, including reduced trading fees, price improvement and increased trade size for the active side, and improved access to liquidity for the passive side. The IntraSpread™ Facility is designed to allow matching of orders between dealers, with additional features designed to maximize benefits for the active, retail order flow and minimize potential for "gaming" the passive liquidity providing flow.

The current IntraSpread™ Facility is based on two order types: Dark order and Seek Dark Liquidity™ (SDL™) order,.

Dark Order

The Dark order is a fully hidden order, used to manage passive interest with no pre-trade transparency, and offer price improvement to tradable incoming orders.

- Dark orders have no pre-trade transparency as information on Dark orders is not disseminated on any public data feeds.

¹ An original proposal was published July 17, 2010. The original Alpha IntraSpread™ Facility, included a set of new order types offered by Alpha ATS, which allowed Subscribers to seek order matches within their firm without pre-trade transparency, with guaranteed price improvement for active orders. It was intended that the IntraSpread™ facility would be available to all Subscribers and for all symbols traded on Alpha ATS.

² CIBC World Markets Inc., and RBC Capital Markets

³ Chi-X Canada, CNSX Markets Inc., and TMX Group

⁴ Additional information is available in the Subscriber Notice and blacklined Trading Policies on the Alpha ATS web site: www.alphatradingsystems.ca

- The price of a Dark order is calculated as an offset of the NBBO by adding the price offset to the National Best Bid for a buy order and subtracting it from the National Best Offer for a sell order. The price of the Dark order can optionally be capped.
- The price offset is calculated as a percentage of the NBBO spread, and can have one of two values:
 - 10% capped to one price tick (i.e. “no more than a penny”), or
 - 50% with no tick cap.
- If either side of the NBBO is not set, or the NBBO is locked or crossed, Dark orders will not trade.
- Dark orders are day only orders and must be for a board lot quantity. Dark orders cannot be Iceberg, On-Stop, Inside Match, AON, FOK, FAK, MOO, LOO, MOC, Special Terms, Bypass, Passive Only, TTM or ROC.
- Dark orders can be amended, including quantity, price offset and price cap, in addition to other standard amendable order attributes.
- Dark orders trade only with incoming SDL™ orders that are tradable at the calculated price of the Dark order. Dark orders do not trade with each other.
- Dark orders are accepted in Pre-Open and Continuous trading sessions (from 7:00am to 4:00pm). Dark orders trade in the Continuous trading session but do not participate in opening or closing auctions.

Seek Dark Liquidity™ (SDL™) Order

The SDL™ order is used to interact with the dark liquidity.

- SDL™ orders are “immediate-or-cancel” - they trade with eligible Dark orders to the extent possible, and any residual is cancelled. Price can be market or limit.
- SDL™ orders only trade with Dark orders and do not interact with other transparent orders in the Alpha CLOB.
- SDL™ orders interact with Dark orders from any Alpha Subscriber.
- SDL™ orders must be for a board lot quantity, and cannot be Iceberg, On-Stop, Inside Match, AON, FAK, MOO, LOO, MOC, Special Terms, Bypass, Passive Only, TTM or ROC.
- SDL™ orders are accepted only during Continuous trading session (from 9:30am to 4:00pm)

IntraSpread™ Trades

- Matching in IntraSpread™ follows the price/broker /smart size/round-robin priority set out below:
 - Price Priority - Dark orders with better price (higher price offset) have priority, then
 - Broker Preferencing - Dark orders from the same Subscriber have priority, then
 - Smart Size Priority - Dark orders with sufficient size to fully fill the incoming order have priority, then
 - Round-Robin Priority - Dark orders take turns in interacting with the incoming order. Each time a Dark order is inserted, it is placed at the end of the queue. Each time a Dark order trades or its quantity is increased, the order is placed at the end of the queue.
- Trades are disseminated on the public data feed in real-time. These trades do not set the Alpha last sale price (ALSP) or the NLSP. Trade prices may have up to three decimal places for prices above \$0.50 and up to four decimal places for prices below \$0.50.

Eligibility

- IntraSpread facility is available to all Subscribers and for all symbols traded on Alpha ATS.

- SDL™ orders can be entered only on behalf of Retail Customers
 - The definition of Retail Customer is based on the definition set out in the IIROC Dealer Member rules.
 - It is expected that Subscribers have policies and procedures in place in regards to identifying which accounts qualify and supervisory procedures to monitor ongoing compliance.
 - If Alpha deems that a Subscriber is allowing SDL™ orders from non-retail clients, Alpha may take appropriate action against the firm regarding access to the Alpha IntraSpread™ Facility.
- Dark orders can be entered without any constraints.

Alpha notes that it has also reviewed the Joint CSA/IIROC Position Paper 23-405 on Dark Liquidity in the Canadian Market which was published on November 18, 2010. While the Alpha revised proposal is generally in line with the policy considerations set out in the paper, we acknowledge that changes may be required if some of the proposals are adopted. Since the outcome of the position paper is unknown at this time, we intend to go ahead with our proposal with the understanding that it may need to change in the future.

Summary of Comments and Responses regarding Alpha IntraSpread™ Facility proposed in December, 2010 (the current proposal)

General Comments

RBC Capital Markets noted that conceptually and functionally, much of what is being proposed is currently available in the Canadian marketplace. It suggested that to state that the Alpha IntraSpread™ Facility is contrary to current rules is “to bring into question the current operational models of various marketplaces, and more specifically, the regulatory underpinnings upon which these marketplaces rely to substantiate their operational models.”⁵

We would point out that many of the issues raised by the commenters, particularly the other marketplaces; were a repeat of issues that were raised during the first comment process and were focused more on competitive issues and the direction they believed the rules should follow than the current precedent. While it is true that new developments may make old precedent irrelevant, the usual process for overturning previous positions is to set out new rules and go through a rulemaking process. We acknowledge the Ontario Securities Commissions efforts, alongside with the other regulators, to engage in a policy initiative which will address any policy concerns that exist.

We would also note that when a marketplace, including exchanges, introduces changes it does not have to show that such changes are the best solution or approach to an issue or client need. It should be permitted to proceed with its proposal unless there is clear evidence of harm.

Fair Access, Internalization and Selective Preferencing

The three marketplaces⁶ acknowledge that the current proposal has removed the internalization feature which limited interaction of orders to the subscribers’ own order flow; however, they raise concerns around what they characterize as having the same impact as internalization because of limiting the SDL orders to retail customers or due to the broker preferencing feature.

CIBC WM, which supports dark pools generally, raised concerns because the SDL is limited to retail customers.

Chi-X expressed concerns that retail orders will not be able to be passive because of the UMIR Order Exposure Rule. It believes that the combination of size priority and broker-preferencing creates the equivalent of wholesale facilities that exist in the U.S.

Chi-X and TMX also suggest that any dealer that does not support a retail business is unable to take advantage of this facility and may disadvantage small institutional dealers.

Alpha Response:

In the Canadian marketplace, we can identify numerous features that do not benefit all participants in the same way, most notably the trading fee tiers that several other marketplaces have in place. Marketplaces like Liquidnet are even limited to a type of customer (institutional) and do not provide any access to other parties. Some order types or even regulatory rules such as the Order Exposure Rule are specifically intended to benefit retail customers. The SDL order is consistent with permitted features or

⁵ RBC CM

⁶ TMX, CNSX and Chi-X

requirements that allow different utility for different customers and different features (size priority is another example of a permitted feature that may differentiate treatment of customers).

Broker preferencing is permitted in the lit marketplaces and there is no different impact when it is allowed in a dark marketplace.

Dealers have always been allowed to choose the business model and therefore the clients with which they wish to deal. A dealer can choose to have an institutional, retail or other specialized business such as discount brokerage business or wholesale facility. Limiting the SDL to retail customers is consistent with this kind of differentiation and does not introduce any new issues.

The Alpha IntraSpread™ Facility was being introduced to provide choice and options to dealers and their clients. It has long been recognized that “one size does not fit all” in the world of investors and trading securities.

There have long existed alternatives to the CLOB such as crossing markets and the upstairs market. Also there is a danger in assuming facts for which there has been no evidence as the basis for stopping innovation.

Although the Alpha IntraSpread™ Facility is constructed to alleviate some of the disadvantages that retail active flow face in today’s market structure, it has been constructed so that all participants(those without retail flow or with little retail flow) can benefit through the use of the Dark order. The Dark orders of any dealer with interact with the SDL orders of their own and/or other of other dealers.

Sub-penny pricing and meaningful price improvement

CNSX directed most of its comments to the fact that there is no meaningful price improvement and the impact of allowing execution such small increments on rules requiring price improvement such as the order exposure rule. It suggests that the views expressed through IIROC policy guidance should be revisited.

Although the TMX acknowledges that sub-penny orders are currently permitted, it states that any dark trading must provide meaningful price improvement over the displayed national best bid or offer and sub-penny price improvement is insufficient.

Alpha Response:

Alpha’s price improvement feature addresses the requirements of the Order Exposure rule for those orders that are executed through the facility. A subscriber/ Dealer will have to comply with the requirements of the Order Exposure rule for any unfilled or partially filled orders that were originally within the size requirements of the Order Exposure rule by using its own or the Alpha RAD™. Currently there is sub-penny pricing for pegged and dark orders as well as for Basis, VWAP and Call Orders. The Alpha Dark order is consistent with current orders available at MatchNow, Chi-X and Alpha as well as the new order types proposed by TMX.

Setting the Last Sale Price

The TSX believes that Alpha’s dark orders should not be classified the same as MatchNow and therefore should set the National Last Sale Price.

Alpha Response:

Alpha relied on the precedent set by MatchNow and its own Price Improvement Iceberg Order. In response to IIROC’s concerns, Alpha has applied to IIROC for a temporary exemption to allow Alpha to have until the earlier of 30 days after it reaches a 5% total market share of activity within IntraSpread™ or December 31, 2011 to put in place the technology changes that will enable the trades that result from IntraSpread™ to set the Last Sale Price.

Comments on our responses to previous comments

CNSX reviewed and had comments on our previous summary and responses. We would like to point out that while we acknowledge it is possible that we either missed some points or even misunderstood some arguments; Alpha used its best efforts to summarize and describe all material points. We do not think is useful to the discussion to review and respond to comments on the previous summary.

Please contact Randee Pavalow at randee.pavalow@alpha-group.ca for any questions.