CNSX MARKETS INC.

January 26, 2011

BY EMAIL

Market Regulation Branch
Ontario Securities Commission
Suite 1903, Box 55
20 Queen Street West
Toronto, ON M5H 3S8

AND –

Ms Randee Pavalow
Head of Operations and Legal
Alpha ATS LP
70 York Street, Suite 1501
Toronto, ON M5J 1S9

Dear Mesdames/Sirs:

Re: Alpha ATS LP ("Alpha") Proposed Changes to the IntraSpread Facility

We appreciate this opportunity to comment on Alpha's revisions to its proposed IntraSpread facility and the important market integrity and investor protection principles it raises.

Background

CNSX Markets Inc. operates both Pure Trading and the CNSX listed market. Both are "lit" trading venues. Our position, consistent with our responses to previous CSA/IIROC market structure initiatives, including the recent response to the Dark Liquidity position paper, is that healthy markets require a sufficient amount of transparency and must be perceived to be fair, and to achieve the latter there must be investor confidence in the price discovery function. We have also stated that we are supportive of dark pools for trading large blocks, as they provide benefits not only to those placing the order, but also the markets generally, by avoiding undue market impact.

General Comments

Alpha's position remains that the IntraSpread proposal should proceed because it fits within precedents established by previously accepted products and is simply maintaining the status quo while the CSA/IIROC project on dark trading is concluded. We continue to disagree with that position. Existing order types/pools were created prior to any significant multi-market experience and with limited public and industry input. As is clearly evident by Alpha's argument, it is critical that the principles, and not just the precedents, are carefully considered because of the pushback regulators receive when they seek to reconsider an approved or accepted product or service. We are also surprised by Alpha's statement that there is no evidence of harm from dark liquidity/internalization, even in the U.S., when the SEC has indicated that they are concerned about the diversion of orders from the public markets and the term "toxic" order flow is a commonplace term to describe what, for the most part, does reach them.

Alpha has stated the benefits of the revised proposal for Intraspread remain the same as the original proposal: reduced trading fees, price improvement and increased trade size for the active side, and improved access to liquidity for the passive side. The revised proposal has features "designed to maximize benefits for the active, retail order flow."

As a starting point, we ask what evidence there is that IntraSpread is likely to increase trade size for the active side, or even that trade size is currently a problem for retail clients? For the passive side, the stated benefit is "improved access to liquidity". Again, we have seen no evidence that a facility that prioritizes the enhancement of internalization of retail order flow would result in this benefit. More generally, we suggest that it is important to be clear on who benefits and at whose cost, not simply that there are benefits.

In our comments on the original proposal, we identified three important, inter-related issues to consider: 1) the impact of increased internalization; 2) what constitutes meaningful price improvement; 3) minimum order entry and trading increments.

We do not believe that these concerns have been adequately addressed in Alpha's responses or in the revised proposal.

<u>1) Internalization</u>

It is a positive development that Alpha has revised the proposal to remove the initial restriction that a subscriber's clients could only trade with the subscriber. There is also no reference to a subsequent phase whereby subscribers would be able preference each other and we trust that if this is still planned, it will be published for comment in due course. However, Alpha's summary of our comments on internalization fell short of accurately capturing our position, stating only that we acknowledged certain benefits of internalization, but were concerned about incremental benefits to subscribers. To be clear, if the cost savings from increased internalization are a benefit to dealer-subscribers at the expense of their clients, we do not believe it should be considered a benefit at all. In our comments, we did say that we did *"not dispute that a widespread cost reduction for all dealers would be a benefit to the industry.."* We were trying to fairly reflect the benefits but also put them into perspective. If a participant were to execute a retail size client-principal cross on a lit market, the client would receive the benefit of at least one full trading increment in price improvement. Under the IntraSpread proposal, if that participant is an Alpha subscriber, they can greatly increase the amount of internalization by providing price improvement at a fraction of a trading increment. The client would receive a better price than what was visible, but less than what would have been required had the order been entered on a lit market. The lion's share of the benefit goes to the subscriber at the expense of the client. This is one example where Alpha's claim that the proposal is no different than the status quo is not entirely accurate.

<u>2) Meaningful Price Improvement</u>

CNSX Markets recently commented on the CSA/IIROC dark liquidity position paper, and in considering dark orders and price improvement we acknowledged there may be some validity to the assumption that dark pools and orders facilitate interaction with otherwise unavailable liquidity. If so, there is therefore a public good in allowing smaller orders to execute against large blocks non-transparently, and we would support the proposal that a smaller dark active order, in this case an SDL, may only be executed where there is meaningful price improvement.

In our comments on the original Intraspread proposal we suggested it was time to revisit the application of price improvement rules. Alpha responded that the argument about price improvement "is not a reason to stop new initiatives that fit within current rules", a position that was supported by the assertion that the rules do not apply because the orders would not be visible. This circular logic is being used to support the creation of two order types that will facilitate trades at prices that would not otherwise be permitted. We believe that the creation by a marketplace of an order type that relies on adding a fraction of a cent of price improvement is inconsistent with intent of UMIR 6.1(1) and Policy 6.1.

An SDL order can only be entered on behalf of retail clients, will only trade with Dark Orders and the unfilled balance cancelled. We would argue therefore that, without the benefit of knowing a Dark Order exists, the entry of a client order as an SDL order is an exploratory exercise and should not constitute immediate exposure to a marketplace in accordance with UMIR 6.3. To operate consistently with the order exposure rule, the unfilled balance of an SDL order should trade with visible orders. Under the proposal however, if an SDL order is not filled the participant would then be required to enter the order again to obtain a price at least as good as the client would have received if it had been executed upon receipt, or, to enter the order against a principal order and provide price improvement to the client. Under IntraSpread, this can be accomplished by the subscriber entering a proprietary Dark Order and entering the client order again as an SDL, claiming to have met the price improvement requirement. In the midst of the policy debate about whether a single trading increment represents meaningful price improvement, Alpha's proposal would allow a subscriber to provide as little as two-tenths of that.

Meaningful price improvement is not just a benefit to the direct recipient, but an integral part of a functioning price discovery mechanism. These two order types will very likely be used to withhold retail orders from lit markets and instead direct them to a facility where a dealer-subscriber can trade against its client flow at a lower cost, but with less benefit to the retail clients.

The cost savings of internalizing a client-principal trade in the IntraSpread facility are a direct benefit to the subscriber, providing even more reason that the client should be filled in accordance with the requirements of UMIR 6.1, 6.3 and 8.1, specifically, price improvement of at least one trading increment.

3) Sub-penny increments

Alpha maintains its argument from the first proposal that the sub-penny pricing is consistent with current rules because the rules only apply to visible markets. CNSX Markets previously commented that sub-penny increments were appropriate for VWAP and basis trades because the price was determined from a number of factors – factors which cannot be known at the time the order is entered. Alpha has responded that the "Dark order is derived from a reference price and should be treated in the same manner." In its revised proposal, Alpha's interpretation of Part 6 of UMIR states that the common factor for the exempted orders (Basis, Call Market, VWAP) is that the price is determined outside of interaction with the central limit order book, and therefore concludes that the rules were designed to apply to lit markets. We note that Alpha's Dark order will be priced directly from the central limit order book, or to be precise, the NBBO. We stand by our position that a price calculated by the marketplace trading system from a number of factors is in no way similar to a subscriber deciding that they are willing to pay, for example, a tenth of a cent higher than the existing bid. This price is "established by the trading system of the marketplace" in the same manner as an order entered with no price limit.

<u>Alpha's Responses</u>

We note that some of Alpha's published responses to comments on the original proposal may not have adequately addressed the concerns expressed in the comments. For example, Maple Securities Canada Limited ("Maple") commented that "Dealers can use the dark market to avoid interference by client orders booked in the visible market" but Alpha did not address that point specifically. This comment is consistent with many of the concerns about sub-penny increments and meaningful price improvement. An Alpha subscriber with significant retail order flow can obtain priority for proprietary orders by paying a tenth of a cent more than an order, even an order from one of its own clients, in the order book.

Maple also suggested that the balance of an unfilled market SDL order should trade immediately with the visible market. Alpha responded that this could be accomplished by designated the SDL order as a TTM order. However, according to Alpha's description of a Seek Dark Liquidity Order:

> *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 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*** [emphasis added] *or ROC.*

Under the revised proposal, as SDL orders will be used for retail client orders, we are curious why the unfilled balance would not simply trade against the visible market, or at least why there would be a restriction on them being designated as a TTM order. A client order entered as such would be eligible for a fill from any available dark liquidity and then filled at the NBBO - resulting in immediate execution at the best possible price.

On the topic of best execution, Alpha's summary of TMX Group comments was "*NI 23-101 requires dealers to make reasonable efforts and tests should be onerous. Trading client orders in an internalized manner with de minimus price improvement on Alpha could not be justified when compared to the trading opportunity on other lit Canadian marketplaces*." This is consistent with our position that Alpha subscribers could enter a retail client order as an SDL and have it trade against a proprietary Dark Order, and claim to have provided both an immediate fill and price improvement. As a client-principal cross on a lit market however, the client would still receive an immediate fill, but more price improvement. Furthermore, no trading fee would currently apply to that cross. There may be savings to the subscriber, but at the expense of the client.

Alpha believes that *"some of the issues being raised are commercial or competitive issues rather than regulatory issues. The fact that Alpha has been successful in achieving a large market share and may be successful in introducing new order types is not a reason for stopping it from proceeding."* In fact, our previous comments raised the issue of Alpha's success as a reasonable basis for concluding that potential impact of IntraSpread could be significant in a short period of time:

> *"...this particular initiative significantly changes the risk profile since it is not being offered by a new entrant with barriers to entry, but by an entity with enormous economic*

clout and the potential to rapidly expand the amount of dark trading in Canada. For these reasons alone the IntraSpread facility should not be implemented without a clear regulatory policy position on key issues such as whether there should be limits on dark trading, and a clear vision of how the health of the pricing mechanism will be monitored."

We maintain our position that the decision to proceed with a facility for diversion of a significant percentage of order flow from the public order books (and therefore the price discovery mechanism) should only be made after careful review and analysis of the impact. It is certainly not appropriate to proceed based on a simple conclusion that there is no evidence of harm to date, when the existing offerings have not been meaningfully supported (or owned) by the intermediaries with the majority of the order flow in Canada. That said, we understand Alpha's position that if they are prevented from offering functionality that is currently being offered elsewhere, then perhaps other products should be suspended pending the outcome of the regulators' deliberations on dark liquidity.

Yours truly,

Mark Faulkner
Director – Listings & Regulation

cc: Ian Bandeen, CEO
Richard Carleton, Vice-President – Corporate Development
Rob Cook, President
Cindy Petlock, General Counsel & Corporate Secretary