1.1.2 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

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

I. Background

On October 2, 2009, the Canadian Securities Administrators (CSA) and the Investment Industry Regulatory Organization of Canada (IIROC and together with the CSA, we) published the CSA/IIROC Joint Consultation Paper 23-404 *Dark Pools, Dark Orders, and Other Developments in Market Structure in Canada* (Consultation Paper), requesting comments on a number of market structure issues, particularly the impact of marketplaces that offer no pre-trade transparency (dark pools), the introduction of new non-transparent order types, and the introduction of smart order routers. We received 23 response letters from a range of respondents including marketplaces, buy side and sell side representatives, and industry associations. A summary of the comment letters received is included at Appendix A of this Notice and a list of commenters at Appendix B.

On March 23, 2010, the CSA and IIROC also hosted a forum to discuss the issues raised in the Consultation Paper and comment letters and to give respondents a chance to elaborate on their views. The morning session consisted of 11 formal presentations and the afternoon consisted of a roundtable discussion. Representatives from marketplaces, dealers and buy-side investors took part in the morning session and addressed questions from a panel consisting of senior executives from both the CSA and IIROC.[1] The afternoon session involved a roundtable discussion among the presenters facilitated by Wendy Rudd, which touched on issues raised in the Consultation Paper and in morning presentations. In addition, there was a luncheon keynote speech by Larry Tabb, founder and CEO of Tabb Group, discussing similar market structure issues in the United States.

Edited recordings of each of the presentations and the roundtable discussion[2] are available on the IIROC website at www.iiroc.ca under the heading "Member Resources" and the subheadings "Member Events – Webcasts/Recorded Events".

We thank those who contributed to the process by both responding to our request for comments or by presenting and participating in the forum. In particular, we thank Ms. Wendy Rudd who facilitated the afternoon session. We have gathered a great deal of information from this process and will be using it to inform our policy-making going forward.

II. Themes of the Forum

We identified a number of themes that emerged during the forum. Many reiterated issues that had been raised in response letters we received, while others went beyond the topics addressed in the Consultation Paper and touched on other market structure issues of interest.

Some of the themes directly related to the issues raised for discussion in the Consultation Paper included:

- the practice of broker preferencing[3] at the marketplace level and internalization of order flow;
- the practice of dark pools sending Indications of Interest (IOIs) to attract order flow;
- the fairness of a marketplace using a proprietary smart order router (SOR) that has access to information on that marketplace that is not otherwise available to other marketplace participants;
- the use of market pegged orders[4] and whether those orders "free-ride" off the visible market;
- whether dark pools should be required to offer price improvement; and
- the use of sub-penny pricing.

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1 The panel consisted of: Louis Morisset, Superintendent, Securities Markets, Autorité des marchés financiers; Susan Wolburgh Jenah, President and CEO, IIROC; David Wilson, Chair of the Ontario Securities Commision; and Sinan Akdeniz, OSC Commissioner.

2 The presentation and roundtable discussions were edited for the purposes of publication by removing housekeeping and other matters.

3 We define broker preferencing to mean a marketplace feature that allows orders from the same participant or subscriber to execute ahead of other orders posted at the same price in a central limit order book.

4 Market pegged orders are orders which automatically and continuously re-price, according to changes in a reference bid or offer.

Issues related to the Canadian equity market structure that were not raised specifically in the Consultation Paper included:

- concerns about marketplace data fee increases with the emergence of multiple marketplaces;
- direct and sponsored access to marketplaces;
- the impact of high-frequency trading on the market; and
- the need for regulators to take a holistic view of the market when considering regulation instead of dealing with specific issues in isolation.

We have compiled a high-level overview of the views expressed both in writing and at the forum and also included below a discussion of ongoing initiatives and proposed next steps to address some of the issues.

a. Broker Preferencing

There were many different views on this issue. Some participants supported the concept stating that in the absence of inter-market time priority that broker preferencing is essentially irrelevant. Others believed that broker preferencing is inherently unfair as earlier orders are bypassed and ignored. A common point of discussion was the concern that the removal of broker preferencing from the Canadian marketplaces might result in dark pools being established by dealers to internalize orders which would reduce transparency. Forum participants also indicated that due to the relatively small number of dealers that control a significant portion of the order flow, additional internalization of order flow at the dealers is a factor that should be considered when analyzing dark pools.

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.

CSA and IIROC staff intend to examine the issue of broker preferencing. We do believe that at the outset, more transparency is required so that market participants understand how all trading options offered by the marketplaces function. CSA staff are considering requiring that marketplaces provide specific disclosure on their websites on how orders entered on a marketplace interact with other orders on that marketplace throughout the day, including a detailed description of each order type. This proposal will be part of a package of amendments to National Instrument 21-101 *Marketplace Operation* (NI 21-101) and National Instrument 23-101 *Trading Rules* that will deal with updating the regulatory regime for alternative trading systems.[5] CSA staff anticipate that the amendments will be published for comment by the Fall of 2010.

b. Dissemination of IOIs by Dark Pools

The main issues related to IOIs disseminated by dark pools in order to attract order flow were:

- the point at which an IOI becomes an order[6] and becomes subject to the transparency requirements set out in Part 7 of NI 21-101; and
- the fairness and transparency of marketplaces’ practices with respect to IOI dissemination.
- CSA and IIROC staff will be monitoring the initiatives taken in the U.S. with respect to “actionable IOIs”. [7] CSA staff believes that enhanced transparency of marketplaces’ practices regarding the dissemination of information respecting orders and trades, including the provision of IOIs, will also address some of the concerns raised.
- CSA staff are also considering providing clarification on the definition of an order and what features would qualify an IOI as an order.

5 This project will be the second phase to related initiatives set out in OSC Staff Notice 21-703 *Transparency of the Operations of Stock Exchanges and Alternative Trading Systems*.

6 NI 21-101 defines an order as meaning a firm indication by a person or company, acting as either principal or agent, of a willingness to buy or sell a security.

7 SEC Release No. 34-60997 (October 21, 2009). The SEC proposed that, if the practical context in which IOIs are transmitted renders them “actionable”, for example if they include sufficient information (including symbol, side (buy or sell), size (minimum of a round lot of trading interest), and price (explicit or implicit) they be included in the definition of “bid” or “offer” in Rule 600(b)(8) of Regulation NMS and thus become subject to transparency requirements.

c. *Use of SORs by Marketplaces*

This issue revolves around the concept of a marketplace-owned smart order router using information about hidden orders on that marketplace when making routing decisions. Although some felt that this practice was not a concern as this is a routing decision only, others thought that all visible orders at a given price should have priority over all hidden orders.

CSA staff are assessing whether the use of marketplace-owned SORs which take into account hidden liquidity available on their own book gives that marketplace an unfair advantage over other marketplaces and SORs. CSA staff are also considering the impact that this practice has on investors and will be examining whether marketplaces that provide information on hidden liquidity to their proprietary SORs should be required to provide the same information to other third-party SORs in order to meet the fair access provisions of NI 21-101.[8]

d. *Market-Pegged Orders*

Some forum participants raised concerns over market-pegged orders, specifically whether market-pegged orders have a negative impact on price discovery because they are simply free-riding the quotes from other marketplaces or whether the unrestricted use of such orders created a disincentive to display liquidity. Others were of the view that many order types are variations of pegs, and that the concept was simply centralizing a process which could be, and is currently, done by dealer algorithms or manually, and thus would result in a reduction of message traffic between market participants. This was also consistent with the majority of the responses to the Consultation Paper, which did not raise concerns with pegged orders. We will continue to review proposed order types from marketplaces.

e. *Price Improvement and Sub-Penny Pricing*[9]

Forum participants discussed the idea of price improvement in dark pools, as well as the concept of sub-penny pricing. Questions were raised whether dark pools should always be required to offer price improvement, how much price improvement is meaningful, and whether sub-penny price improvement is desired or even relevant. It was noted that sub-penny price improvement may only be meaningful for dark pools achieving block sized execution, but is of questionable benefit to the overall market or to the investors for small orders. Participants also discussed the fairness of allowing dark pools to offer sub-penny price improvement while transparent markets are not allowed to offer the same execution opportunities. Some participants felt that sub-penny quoting on visible exchanges would not be desirable, one reason being the impact of increased messaging due to sub-penny pricing and marketplaces' technology infrastructure costs.

We will examine the issue of sub-penny pricing with the goal of assessing how any changes in either printing or quoting in sub-pennies would impact both the market as a whole, and the individual participants. Additionally, we will consider both transparent and dark markets, and whether principles of fairness would allow both types of venues to offer sub-penny price improvement and printing or execution, or whether different market structure models necessitate different treatment.

f. *Market Data Fees*

Participants expressed concern that marketplace data fees are too high, especially in today's multiple marketplace environment where dealers need to consider data from all appropriate marketplaces, and not just those where a dealer is a participant. Some believed that dealers are, in effect, "captive consumers" of marketplaces' data, and that current fees for such data may not be commensurate with the marketplaces' market share or value of their data.

The CSA are currently conducting a review of all fees charged by marketplaces, including data fees. CSA staff's goal is to ensure that the costs involved with accessing services provided by marketplaces, including data, trading and routing are compliant with the fair access provisions in NI 21-101.[10]

g. *Electronic Trading and Direct Market Access*

Some participants indicated that the regulators should examine the issues surrounding direct market access.

8 Subsections 5.1(b) and 6.13(b) of NI 21-101 require exchanges and ATSs, respectively, to not unreasonably prohibit, condition or limit access by a person or company to services offered by them.

9 Subsection 6.1(1) of the UMIR does not allow the entry of orders on a marketplace at a price that includes a fraction or a part of a cent, other than orders with prices of less than $0.50 which may be entered to trade at an increment of one-half of one cent. However, executions for certain specialty orders (such as basis, call market or volume-weighted average price orders) may occur at sub-penny increments and may be reported in that fashion if permitted by the information processor or by the information vendor used by the marketplace.

10 NI 21-101 5.1 and 6.13 state that exchanges and ATSs must not unreasonably prohibit, condition, or limit access by a person or company to services offered by it. As indicated in Companion Policy 21-101CP, these includes services related to data.

In April 2007, the CSA and IIROC published proposals relating to direct market access. Since that time, the market has changed, technology has significantly advanced and regulatory regimes governing direct market access have changed in other jurisdictions. As a result, CSA and IIROC staff have embarked on a broad scope review of electronic trading in Canada, including direct market access practices, with a view to assess what requirements are needed to address credit risk, market risk and systemic risk to the Canadian market. The objectives of the review of electronic trading include assessing what controls, filters and other mechanisms marketplaces and market participants should have to prevent errors at the order-entry stage and, in general, to promote fair and orderly markets.

As a result of the market volatility experienced on May 6th, 2010, we have expanded the scope of the project to include the examination of other electronic trading issues, including the need to standardize the volatility parameters used by Canadian marketplaces in times of extreme volatility.[11]

h. High Frequency Trading

It was suggested at the forum that regulators also review high frequency trading, particularly as its growth may have impacted time priority benefits and the ability of some market participants to achieve trade execution. We continue to monitor developments in this area, and particularly recent initiatives in the U.S. aimed at reviewing short-term trading strategies and their impact on the market. A review of issues associated with high frequency trading was also included in the scope of the project to examine electronic trading discussed above.

IIROC staff continue to monitor changes in patterns of trading on Canadian marketplaces, and the impact of "high frequency trading" is included in that monitoring. Changes in technology and the development of competitive multiple marketplaces have significantly increased message traffic and order to trade ratios. Future rates of growth in high frequency trading will be dependent upon decisions which may be made with respect to such issues as sub-penny pricing.

i. Other

A few forum participants were concerned that the scope of the Consultation Paper and of the forum discussions was limited to issues related to dark pools and certain order types. They indicated that the CSA and IIROC should expand their review and take a holistic view of the markets rather than considering the issues separately.

We believe that we are accomplishing this through our review of the issues discussed above. These issues are not considered in isolation and are, in many cases, related. We believe that our approach also allows us to focus our consultation with market participants on specific issues and to elicit meaningful comments.

III. Conclusion

In the last few years, we have experienced significant developments in the Canadian capital markets. Most notably, the introduction of multiple marketplaces, which have different features and business models, has given rise to new market structure issues. We have described a number of initiatives currently in place to address such new issues. As we are working through these initiatives, we welcome any input and perspective of market participants. If you have any comments or questions, please contact any of the CSA or IIROC staff listed below.

Ruxandra Smith
Ontario Securities Commission
(416) 593-2317

Tracey Stern
Ontario Securities Commission
(416) 593-8167

Serge Boisvert
Autorité des marchés financiers
(514) 395-0337 ext. 4358

Lorenz Berner
Alberta Securities Commission
(403) 355-3889

Kent Bailey
Ontario Securities Commission
(416) 595-8945

Elaine Lanouette
Autorité des marchés financiers
(514) 395-0337 ext. 4356

Doug Brown
Manitoba Securities Commission
(604) 899-6658

Michael Brady
British Columbia Securities Commission
(604) 899-6561

James Twiss
IIROC
(416) 646-7277

[11] Currently, some marketplaces use "freeze parameters" on their trading engines that allow them to freeze trading in specific securities where a significant price change occurs. This allows them to determine if a sudden price movement is due to potential erroneous trades. Currently, the use of these parameters is not consistent across the marketplaces.

APPENDIX A

CSA/IIROC Joint Consultation Paper 23-404
Dark Pools, Dark Orders, and Other Developments in Market Structure in Canada

Summary of Comments

In response to the CSA/IIROC Joint Consultation Paper 23-404 (Consultation Paper), 23 comment letters were received. The commenters included buy and sell side representatives, transparent and non-transparent marketplaces and industry associations. A summary of the comments is presented below.

General considerations
Most commenters, which included the vast majority of the buy-side respondents, believed that there were benefits from having dark pools and dark order types. For example, they indicated that dark pools may result in lower trading costs, they provide investors with more choice, encourage competition, allow asset managers to trade large blocks of securities without information leakage, and play an important role in achieving best execution.

The views of the marketplace representatives that provided comments were mixed. Some stressed the importance of transparency in the price discovery process and believed that, while dark pools may serve the investors' interest in the right circumstances, their use may be detrimental to price discovery and liquidity. Others believed that dark pools operate with interdependencies with the transparent marketplaces, and help increase total liquidity and benefit investors. The latter group also highlighted the benefits of dark pools, such as the fact that they protect the confidentiality of institutional block orders, increase liquidity by allowing these orders to interact with other orders, including but not limited to block orders, and that they contribute to price discovery.

A few respondents supported additional regulatory requirements, such as a requirement on dark pools to disclose their method of operation, order routing and communication of indication of interest (IOI) practices, requirements on dealers to be transparent regarding their decisions to route orders to dark pools and how their decisions comply with best execution, or a requirement that only large block trades be executed in dark pools. Some commenters, however, indicated that with the low volume of trading in dark pools (less than 2% of the entire Canadian market) and the lack of empirical evidence to analyze issues relating to Dark Pools, it is premature to consider regulatory action at this time. It was also suggested that there are other issues in the existing marketplace that should be scrutinized by the regulators such as, for example, high-frequency trading. One commenter noted that many changes have recently occurred in the marketplaces, and recommended the establishment of a committee of experts to ensure the CSA are kept apprised of issues surrounding rapidly changing markets.

It was also suggested that any discussion of non-transparent trading should expand beyond trading on marketplaces and should consider dealer internalization.

The questions in the Consultation Paper and a summary of the responses are included below.

Question 1 – While trading on Dark Pools has not been extensive in Canada, please provide your views on the actual and/or potential impact of Dark Pools on:
a) Order size
b) Price discovery
c) Liquidity
d) Market fragmentation
e) Trading strategy
f) Client instructions
In your view, what will be the potential impact if the market share of Dark Pools in Canada increases significantly?

Order size
Most commenters were of the view that dark pools would have little effect on order size. Some noted that there has been a general decrease in order size in the Canadian marketplace, but did not attribute this to the emergence of dark pools. Some respondents believed that, when used by large institutions, dark pools could in fact increase order size through the execution of large blocks. However, one buy-side commenter noted that the average trade size on dark pools is very small, suggesting that orders are merely being moved from visible to dark markets.

Price discovery
The majority of the respondents did not believe that dark pools impair price discovery, and some thought that they actually have a net positive benefit to price discovery resulting from post-trade reporting and in some opinions, the ability to attract large orders away from the upstairs market. Some indicated that dark pools have a less substantial negative impact on price discovery than the upstairs market has. However, a few respondents were of the view that dark pools undermine the price

discovery process, especially where dark pools attract orders from lit markets. Some thought that they offer little or no value to the price discovery process.

Liquidity
The question of liquidity brought mixed opinions, but most respondents believed that they would have a positive impact on liquidity. Most of those who believed that liquidity was enhanced made the assumption that dark pools were in fact successful in attracting latent interest to the market, and were not simply drawing existing orders from lit venues. Some dealer firms believed that dark pools are merely removing liquidity from visible markets and that, if dark pools are not accessible by everyone, liquidity would in fact be reduced.

Fragmentation
Most commenters agreed that dark pools would add to market fragmentation. Some noted, however, that there is fragmentation in the marketplace already due to the existence of the upstairs market, which caters to big blocks, and dark pools would not increase it. Others thought that the competition and innovation resulting from multiple marketplaces would provide a net benefit despite the inherent fragmentation. Many thought that the increased use of technology in the marketplace, and the fact that marketplaces are increasingly interconnected due to the use of Smart Order Routers (SORs) may address market fragmentation concerns.

Trading strategy and client instructions
The question regarding trading strategy and client instructions was not widely commented upon, however most of those who responded were of the opinion that both trading strategies and client instructions would continue to become more sophisticated and detailed, and that this would be a net benefit to participants. It was noted that dark pools support different types of trading strategies which are important to investors. One commenter questioned whether these sophisticated strategies would come at the expense of the retail investor. One indicated that dark pools increase the use of algorithms, electronic trading and SOR technology, which would allow institutional investors to play a greater role in trading decisions though their direct market access.

Impact if dark pool market share increases significantly
The responses varied. Some thought that increased market share by dark pools would have a positive effect as it may attract previously undisclosed liquidity. Some believed that an increase in market share of dark pools would have little, if any impact on the Canadian market. Other possible consequences identified by commenters were: increased use of technology and associated costs as there will be a need to connect to all marketplaces to access liquidity; narrowing of the spreads; and reduced market impact costs.

Question 2 – Please provide your views on whether there should be a minimum size requirement for orders entered on Dark Pools.

In response to the question of imposing a minimum size for dark pool orders, the responses indicated a split in opinion. Although almost all comments from the marketplaces were against minimum size requirements, the opinions from both dealers and buy-side firms varied. Some felt that this decision should be left up to the dark pools themselves, while others indicated that minimum sizes such as 50 trading units, or $100,000 CAD value, might work to protect the lit markets and contribute to improved price discovery and liquidity.

Question 3 – Please provide your views on whether Dark Pools should be permitted to send IOIs. If so, what information should be permitted to be included?

The responses varied. Some commenters thought dark pools should be allowed to send IOIs, others that dark pools should be allowed to send IOIs only if their policies are transparent to users. Some thought the IOIs should not be sent at all, as they leak information, which runs counter to the very reason for the existence of the dark pools. A common theme amongst responses was that client or subscriber consent to IOIs, as well as full disclosure of IOI policies by dark pools, were essential. Some commenters believed that issues with IOIs become apparent when these messages are sent to only a small segment of the market. Others felt that that the decision regarding who should receive such messages should be dependent on the structure of the dark pool in question. A couple of commenters indicated that IOIs should be used for routing decisions only, and not trading decisions. A few thought that the dark pool subscribers should be made aware of, and consent to, disclosure of the IOI before they can be disseminated by the dark pools.

Question 4 – Please provide your views whether or not Dark Pools should be permitted to select which destinations are able to receive IOIs. In your view should the ability to select which destinations receive IOIs be offered to subscribers?

While the views of the respondents were mixed, most thought that allowing dark pools to select destinations for the IOIs they receive would create an unlevel playing field and a two-tiered market with some having access to information that others do not. Some indicated that it should be the subscribers of the Dark Pools that have the ability to select the destination for their IOIs, based on their clients' interest. A few thought that it is important that dark pools have the flexibility to target recipients of communications and that this could be based on commercial relationships, business goals and needs, technology and probability of execution.

Question 5 – In your view, when does an IOI provide sufficient information to require it to be treated like an order that should be subject to pre-trade transparency requirements?

Responses about when an indication of interest actually becomes an order reflected differing opinions amongst commenters. The information in question relates to details about security symbol, order size, side and price. Many commenters believed that any IOI which establishes certainty in all four factors would constitute an order and should require pre-trade transparency. At the opposite end of the spectrum, some felt that any and all information which leaves a dark environment should immediately be transparent to all participants.

Question 6 – What kind of transparency regarding practices of sending IOIs should be made by dark pools to their subscribers?

Generally, respondents agreed that there should be transparency of dark pool practices regarding IOI information. One commenter suggested the information disclosed include a description of the IOI recipients and of the information that will be included in the IOIs, but most did not specify the type of disclosure that should be provided. A few respondents thought that disclosure of IOI practices should be made not only to subscribers, but also to the broad market.

Question 7 – Should Dark Pools be required to provide full or partial transparency of their orders if a threshold of trading activity is reached?

The views of the majority of respondents were similar with respect to this topic, and most agreed that dark pools should not be subject to these requirements. Some noted that this would undermine the very purpose and value of dark pools.

Question 8 – What are your views on the fairness of broker preferencing?

Most marketplace commenters indicated that broker preferencing was inherently unfair, however regulating the practice could result in greater negative consequences in the form of dealer-sponsored dark pools. Also voicing the same concern about dealer pools were the buy-side respondents, however their opinions on the fairness of broker preferencing were generally mixed. One commenter suggested a minimum transaction size in order for a broker-preferenced match to occur. Responses from dealer representatives varied, with some supporting the practice, and others indicating that it should only be allowed if the marketplace chooses to provide it, and others indicating that pure price-time priority is the only method of ensuring fairness to all participants.

Question 9 – Are there other issues that should be considered in connection with dark pools?

In addition to the issues raised in the responses to Questions 1 through 8, the respondents noted that:

- dark pools should not provide advantages to their users other than pre-trade opacity
- the goal should be to maintain a symbiotic relationship between the dark and lit markets to encourage liquidity
- the dark pools should only be allowed if they provide price improvement
- dark pools should be required to disclose rules and publish rule amendments for public comment to allow the public to monitor developments and comment before implementation of rules that may impact market structure

It was also noted that the needs of institutional investors in executing large block trades are different than those executing retail orders, as large trades have market impact while small trades do not.

Some commenters reiterated their recommendation that the upstairs market should be reviewed as well, as they believed it is much less transparent and fair than dark pools.

Question 10 - Please comment on the actual and/or potential impact, if any, of Dark Orders on: a) price discovery; b) liquidity; c) clients' execution instructions; d) trading strategy.

Many commenters reiterated their responses to Question 1 when discussing the impact of Dark Orders. In addition, they noted the following:

Price discovery
In response to the question regarding price discovery, some also indicated that visible elements of dark orders (such as the visible portion of an iceberg order) contribute to pre-trade discovery, and others thought that dark orders assist in providing price discovery by interacting with visible liquidity.

Liquidity
With respect to the impact of such orders on liquidity, the views were split between respondents that thought dark orders would increase liquidity, for example by attracting latent liquidity which would otherwise wait on the upstairs market or by allowing more liquidity to be brought into the market instead of being negotiated off-market, and others who thought that a natural progression toward dark orders would reduce liquidity.

Client's execution instructions and trading strategy
Some commenters thought that clients may not make full use of dark orders, as they are not aware of the various dark order types. One respondent noted that, while dealers are responsible for best execution and should be the ones making the decision whether to use dark orders, clients should also be aware of the dark orders that their dealers consider for trading.

The commenters agreed that dark orders would increase the options available to any trading strategy, and some indicated that providing traders with more tools to bring liquidity to the market is preferable to restrictions in dark order types.

Question 11 – Please comment on the effect, if any, of the interaction of Dark Orders with visible limit orders on fairness and price discovery.

The majority of respondents had no issues with dark orders interacting with visible limit orders, provided that the visible orders or the visible portion of dark orders, always maintains priority. One commenter was of the view that certain types of dark orders were unfair, and that orders should be subject to a trade-off between the price improvement of dark fills, and the immediacy from lit fills. The commenter felt that no order should be allowed the opportunity to hold both a position in a protected book, as well as the opportunity to execute inside the posted spread. One respondent was of the view that all orders should be visible or partially visible, to interact with visible orders.

Respondents' opinions on this subject began to differ when discussing fully-hidden orders posting at prices inside the prevailing spread. Most commenters representing marketplaces had no concerns with the practice, however some dealers and some buy-side participants expressed reservations. Some felt that minimum tick rules should apply, with no sub-tick pricing allowed, while others believed that only deterministically priced orders (i.e.: mid-point matches) should be able to participate. At the other end of the spectrum, some were of the opinion that no fully-hidden orders should be allowed.

Question 12 – Should there be a minimum size requirement for certain Dark Orders? If yes, please explain.

The majority of commenters thought there should be no minimum size requirement, for reasons including the fact that this would limit alternatives available to investors, or that such restrictions would create a two-tiered market with reduced opportunities to trade. A few thought there should be a minimum size requirement, and others thought it should be up to the marketplace to decide.

Question 13 – Should a transparent marketplace allow fully-hidden orders to post at prices inside the prevailing spread (or should at least a portion of the order be required to be exposed, thereby removing the spread)?

The responses were split between those who believed that hidden orders should be allowed to post inside the prevailing displayed spread (these being mainly marketplace and some dealer commenters), and those who thought transparent marketplaces should only execute trades at the best bid or best ask. Reasons for allowing trades to be executed at prices inside the prevailing spread were the potential price improvement and compliance with best price and order protection obligations, as well as the ability of marketplaces to create innovative products that address customers needs to achieve best execution. Reasons against orders posting at prices inside the prevailing spread were lack of consistency with the transparent order types, and concerns regarding the loss of price priority by visible orders.

A few respondents indicated that a portion of the hidden orders should always be exposed, thereby limiting the spread. One of the reasons given was to allow market participants fair access to information.

Question 14 – Should marketplaces be required to provide priority to visible orders over Dark Orders at the same price?

The vast majority of respondents thought that visible orders should be given priority over dark orders at the same price, for reasons including: the fact that market participants taking the risk to display their order should be rewarded by being given priority; to promote price discovery; and the risk that liquidity would be negatively impacted if dark orders were given priority, as there would be no incentive to post transparent orders.

One commenter however, thought that whether to give priority to visible orders should be a marketplace's choice and should not be mandated.

Question 15 – Are there other issues that should be considered in connection with Dark Orders?

Commenters raised a few items for consideration, as follows:

- technology advancement should not be impeded, as long as trading practices are not manipulative and deceptive
- whether last sale price information should be marked differently if it is a dark to dark order or a dark to light order
- whether trades resulting from dark orders within the spread should set the last sale price
- whether dark orders executing within the National Best Bid and Offer (NBBO) spread should be marked as dark order trades

Question 16 – Please comment on the actual or potential impact if any, of market pegged orders on: a) Price discovery; and b) Fairness

Most commenters, especially buy-side and dealer representatives, thought pegged orders enhance liquidity and price discovery. Some noted that dealers already use pegged orders through both trading systems and algorithms and thought that such orders, if available at the marketplace level, add fairness as they will be available to all participants. A few were of the view that pegged orders contribute to price discovery and are fair, but only if a portion of such orders is visible. Some commenters stressed the importance of being able to re-price orders on a timely basis, and noted that the introduction of pegging functionality at the market level reduces the risk and inefficiencies of limit order re-pricing, which used to be done manually.

The views of marketplace respondents were mixed. For example, some thought that pegged orders can provide additional liquidity but only if they are dark, while another commenter thought that they should be displayed in order to provide price and volume discovery.

Question 17 – Although this paper has not specifically addressed pegged orders that execute at the mid point of the NBBO, in your view, should market pegged orders be allowed to execute at prices unavailable to transparent orders (e.g. at a price between the bid and the ask when the spread is a single trading increment)?

There was variation in opinion with respect to the topic of sub-penny execution. Some felt that it was inconsistent and unfair to the general market to allow dark pools to offer sub-penny pricing, and not permit visible marketplaces to provide the same, and a few believed that allowing sub-tick execution penalizes those participants who have placed visible bids. Conversely, other commenters thought that by not allowing pegged orders to execute at the midpoint of the NBBO, this would restrict trading option and it would not be possible to provide price improvement where there is a one-cent spread.

Question 18 – Although this paper has not specifically addressed pegged orders that are fully-hidden, in your view are there any issues that arise due to fully hidden market pegged orders?

As set out before, some respondents thought that pegged orders should be fully hidden in order for them to provide additional liquidity, while others thought that if fully hidden, they do not contribute to price discovery. One commenter added that, with proper regulation, fully hidden orders would not take priority from displayed orders.

Question 19 – Are there other issues that should be considered with regard to market pegged orders?

Other matters raised were:

- the fact that automatic re-pricing of pegged order at the marketplace level will reduce message traffic
- the fact that fully hidden pegged orders will have less of an impact on market data messaging
- there was a suggestion that the regulators set out a 10% minimum increment for the pegged order's execution price
- there was a suggestion that the regulators analyze who uses marketplace pegged orders and why they are used, and should determine whether investors are disadvantaged by these order types

Question 20 – What is your view of a marketplace SOR taking into consideration hidden liquidity posted on that marketplace when making routing decisions? Is it appropriate? Should the information be required to be provided to

other participants? Should a marketplace's SOR be allowed to take into account hidden liquidity only after all visible liquidity at the same price on all marketplaces is executed against?

Respondents were generally in agreement that a marketplace SOR should be allowed to take into account hidden liquidity on that marketplace, and most saw no issues with this practice as long as subscribers were fully informed. However, a number of participants felt that visible liquidity across all marketplaces should be exhausted first, and that SORs should not be developed in a way that disadvantages those who post visible orders.

Question 21 – Is the practice of a SOR taking into account hidden liquidity posted on a marketplace an example of internalization of order flow? What are the similarities and differences with a dealer internalizing order flow?

A few commenters thought this practice would be akin to internalization of order flow, as the SOR would be accessing information that is not communicated to all marketplace participants. However, most respondents did not think taking into account hidden liquidity posted on a marketplace is internalizing. The latter group noted that internalizing only occurs when orders from the same dealer interact, and that SORs taking into account hidden liquidity do not take into account any specific participant, and crosses are merely coincidental.

Question 22 – What are your views on internalization generally?

Most respondents, especially dealer and buy-side representatives, were in support of internalization. They thought the practice reduces latency and trading and clearing costs and improves client fill rates. However, some commenters, especially the marketplaces, thought internalization can harm the quality of the markets by weakening price transparency, liquidity and price discovery. A few thought that internalization should be subject to additional regulatory oversight.

Question 23 – What is your view on databasing?

The majority of commenters had no issue with the concept of databasing, and many felt that innovation in technology should be considered a benefit.

Question 24 – Please comment on whether there are other issues that should be considered in connection to SORs using hidden liquidity in routing decisions.

Commenters raised a number of points, including:

- regulation should not stifle innovation
- that SORs use of hidden liquidity has occurred in the U.S. without negative impact
- that use of hidden liquidity should be subject to providing clear transparency on how it works

Question 25 – Are there any other issues not discussed in this paper that should be considered for discussion at the round table that will be convened after the publication of this paper?

A number of issues were raised for consideration, as follows:

- the need for regulatory scrutiny of high frequency trading and electronic market making
- the need for scrutiny of activities occurring in the upstairs market
- the impact on technologies of increased message traffic due to market pegged orders and certain dark orders
- the need to discuss and review regulatory developments in US and Europe to reduce potential for regulatory arbitrage
- establishing acceptable minimum standards to operate ATSs and dark pools

Question 26 – In what way if any, do you believe that the combined potential of these developments represents a risk to the market?

There were different responses to this question. Some commenters thought that there is no evidence of systemic risk resulting from dark pools and dark orders, others noted a potential negative impact of dark pools and dark order types on price discovery, market fairness and integrity. One respondent thought that the market developments discussed in the paper may have a unique impact on Canada, where there are a few players managing large pools of liquidity, and stressed the importance of price discovery.

APPENDIX B
List of Commenters

1. Alpha ATS
2. BMO Capital Markets
3. Canadian Securities Traders Association
4. CNSX Markets Inc.
5. Chi-X Canada
6. CIBC World Markets
7. Connor, Clark, & Lunn Investment Management Ltd.
8. Greystone Managed Investments Inc.
9. Highstreet Asset Management Inc.
10. Investment Counsel Association of Canada
11. Investment Industry Association of Canada
12. Investment Technology Group
13. Instinet Canada Ltd.
14. Liquidnet Canada Inc.
15. Newedge Canada Inc.
16. National Bank Financial
17. Omega Securities Inc.
18. Penson Financial Services Canada
19. RBC Dominion Securities Inc.
20. RBC Asset Management Inc.
21. TD Asset Management Inc.
22. TD Securities Inc.
23. TMX Group