January 16, 2009

Alberta Securities Commission
Autorité des marchés financiers
British Columbia Securities Commission
Manitoba Securities Commission
New Brunswick Securities Commission
Nova Scotia Securities Commission
Registrar of Securities, Department of Justice, Northwest Territories
Registrar of Securities, Government of Yukon Territory
Registrar of Securities, Legal Registries Division, Department of Justice, Nunavut
Registrar of Securities, Prince Edward Island
Saskatchewan Financial Services Commission
Superintendent of Securities, Newfoundland and Labrador
Ontario Securities Commission

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and

Madame Anne-Marie Beaudoin
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Dear Sirs and Mesdames,

Re: Proposed Amendments to *National Instrument 21-101 – Marketplace Operation* and *National Instrument 23-101 – Trading Rules* published October 17, 2008

We commend the Canadian Securities Administrators on the work that went into these proposed amendments and for the overall effectiveness these rules should have in meeting the underlying policy goals of incenting and protecting price discovery.

We address certain of the questions posed by CSA staff (reproduced in bold).

Question 1: Should marketplaces be permitted to pass on the trade-through protection obligation to their marketplace participants? If so, in what circumstances? Please provide comment on the practical implications if this were permitted.

We believe it is critical that the new trade-through regime be flexible enough to permit dealers the right to assume the trade-through obligation on their own order flow.

To be clear: the default requirement would be for marketplaces to provide trade-through protection; however, in the instances discussed below, a dealer could assume such responsibility for its orders, in which case the marketplace's obligation is suspended.

Rationale – recognizing relative latencies between smart-order routing solutions. We have spoken to dealers that want to retain control over routing choices, rather than give marketplaces the sole authority to make routing and execution decisions. These are dealers with smart routing solutions that have, by any measure, very short latencies in reading market data and in sending execution instructions to the appropriate venue. In circumstances where a dealer has faster routing technology than the marketplaces it is connected to, but must rely on the trade-through protection systems of those marketplaces, that dealer will experience inferior fill rates and cause increased instances of trade-through than if it smart-order routed on its own.

CSA staff implicitly acknowledges the advanced technological capabilities of certain dealers on page 8 of the Appendix B Cost-Benefit Analysis:

> *Some dealers have implemented monitoring and routing systems to address a business need as well as meet regulatory requirements. Firms that have high trading volumes and want to take advantage of low latency trading would arguably invest in this technology whether or not there is a trade-through rule. Because these firms are able to exploit the available economies of scale, the cost per-client or per-trade is expected to be reasonable.*

Rationale – past and future investments made in industry solutions. By allowing a dealer "opt out" of marketplace-level protection, the CSA would be recognizing the fact that significant resources have been devoted by dealers and third-party vendors in developing smart-order routing solutions to satisfy the current IIROC Best Price regime. Assuming the final CSA trade-through regime is implemented in the second or third quarter of this year, the industry as a whole will have undergone over two years of development work towards meeting the need to route orders to multiple marketplaces based on "best price". The transition costs of moving to a new marketplace-only trade-through regime will be significant and render much of this past work irrelevant. And in looking ahead, dealers will be more likely to forego further investment in leading-edge smart order routing technology, which in turn could have an adverse impact on trading technology innovation in Canada.

Rationale – reducing the concentration of power. The other policy concern is that this proposed regulation will create a statutory monopoly over order-routing in favour of marketplaces. As we address in greater detail below, rules are required to mitigate the inherent conflict of interest in a marketplace acting as its own order-router vendor. A related issue is that the regulators may be granting something of a commercial windfall to marketplaces best able to aggregate order flow. In other words, marketplaces with the largest market share may be able to extract commercial concessions from other marketplaces as a condition of routing (*e.g.*, when the dominant Marketplace C has to choose between Marketplace A and Marketplace B in the case of a "tie", it will route to Marketplace A first on the basis of some ancillary commercial arrangement). We believe this "asset" (*i.e.*, order flow) belongs first to the originator of the order (*i.e.*, the dealer client, or the dealer itself if trading as principal) and secondarily to the dealer (if acting as agent). By locating the right to route orders *solely* at the marketplace level, this regulation will increase the distance between the rightful owner of this asset and the party in the best position to commercialize this asset. On the other hand, by allowing dealers to assume the trade-through obligation, such regulatory monopoly will be limited by forces of competition.

Intermarket Sweep Order concept limits unnecessary re-routing ("race conditions"). The concept of the intermarket sweep order ("ISO") used in the United States and as proposed in NI 23-101 is a practical admission of latencies between marketplaces in reading each other's market data and in routing away. The ISO is, in effect, an instruction to the receiving marketplace: "do not route this order away, even if at the moment of receipt that appears to be a better price away". For example, Marketplace A receives a buy order on XYZ for $10.00 and immediately routes away to Marketplace B which has the best offer on XYZ at $10.00; at the time of receipt of the rerouted order, Marketplace B discovers that Marketplace C is now offering XYZ at $9.99 – if Marketplace A's order is not marked "ISO", it will be rerouted again. The obvious dangers on not having an ISO concept in place are: (i) dramatically increased telecommunications message traffic as orders get rerouted by marketplaces multiple times (which is a burden on marketplace systems and the IIROC monitoring system), and (ii) delayed and/or inferior fills as rerouted orders "chase" outdated quotes.

In a similar fashion, if certain dealers have adopted leading-edge routing technology which is superior to that employed by some or all marketplaces, they should be given the right *not* to have their orders rerouted or otherwise subject to trade-through protection.

Specifics. Dealers should be permitted flexibility to assume this responsibility in their arrangements with each marketplace. Provided the dealers use an ISO marker, or other industry-recognized order marking that instructs the marketplace not to route-away or otherwise "trade-through protect" the order, then the marketplace will not be responsible for trade-through protection on that order. If any order is not marked in that fashion, the default is that the marketplace must provide trade-through protection.

IIROC would continue to surveil instances of trade-through, as it does today. If it detects patterns of trade-through, IIROC's first action would be to contact the marketplace; if the marketplace establishes from its FIX logs that the orders in question were "ISO marked" by the dealer, then IIROC would further investigate that dealer's trading patterns – both on that marketplace and on other marketplaces where the dealer also took responsibility for trade-through. Where a dealer consistently fails to meet IIROC-determined industry minimums of unintended trade-throughs, or where a dealer negligently or intentionally trades-through better-priced orders, the dealer would be required to default to marketplace-level trade-through protection on all of its orders. Such dealer should be permitted an opportunity to re-assume the trade-through obligation only it has reasonably established that it has adopted new technology systems and policies and procedures to address trade-throughs.

Companion Policy Language. Something to the effect of the following could be added to the Companion Policy discussion to address this:

> A marketplace's policies and procedures may permit any requesting participant to voluntarily assume responsibility for trade-through protection. This may occur, for example, in situations where a participant believes its systems for reading market data and routing orders are superior to those of the marketplace in question in executing against the best available visible liquidity or otherwise wishes to retain primary control over how that participant's orders are routed. Such assumption of responsibility must be voluntary and cannot be a condition of accessing a marketplace. The dealer must mark each order for which it is assuming trade-through responsibility in a recognizable manner (*e.g.*, as an intermarket sweep order). Should the regulation services provider determine that such a participant's incidences of trade-through are exceeding applicable industry norms, or that the participant is intentionally causing trade-throughs to occur, then the participant may be subject to remedial orders including the loss of the entitlement to assume the trade-through protection responsibility for a specified period of time or subject to other reasonable conditions.

Question 2: What length of time should be considered an "immediate" response by a marketplace to a received order?

We would propose the U.S. standard of three consecutive attempts resulting in no response within one (1) second.

Question 4: Please comment on the various alternatives available to a marketplace to route orders to another marketplace.

There are three basic alternatives: (1) utilize in-house or related-party capability to smart order route; (2) license a stand-alone third-party capability to smart order route; or (3) do not route but rely on other methods of trade-through protection (such as price-improving the order to a non-offending price level, or rejecting the potentially offending order).

As of the writing of this comment letter, all five protected marketplaces have built or are building capability along the lines of one of these models: (1) Chi-X and Alpha; (2) TSX and Pure; and (3) Omega.

Question 5: Should the CSA set an upper limit on fees that can be charged to access an order for trade-through purposes? If so, is it appropriate to reference the minimum price increment described in IIROC Universal Market Integrity Rule 6.1 as this limit?

We believe that the language proposed in section 10.2(b) of NI 21-101 is necessary and sufficient to control pricing abuses related to prejudicial/differential pricing (*i.e.*, to prevent marketplaces from levying one tier of execution fee on orders originating on their own marketplaces and a higher tier of execution fee on orders routed to them from other marketplaces).

However, for the reasons discussed below, we believe that the language in 10.2(a) could result in adverse consequences and is too restrictive for what we assume is the policy rationale. Rather than adopt the language in 10.2(a), we recommend that the CSA (i) first define, in a CSA staff notice, what would constitute a pricing abuse warranting an explicit fee cap, and (ii) move to implement any necessary rule change only if there is clear evidence that such pricing abuses are occurring or are imminent based on announced pricing changes.

(As an aside, it is unclear to us whether the language in 10.2(a) is intended to apply only to pricing on ISO orders (narrow view), or to all orders executed on the marketplace, which by definition must be effected in compliance with what is effectively an inter-market price-priority requirement (wide view). Our response to this Question 5 is based on a plain reading of section 10.2(a) as covering execution fees for *all* orders executed on a marketplace in compliance with the trade-through requirement.)

Jurisdictional Authority. We do not believe that the CSA have been granted legislative authority to set general marketplace execution fees or any form of fees involving marketplace executions. We base this on a review of section 143 of the *Securities Act* (Ontario) and assume the other provinces have substantially similar language in their enabling statutes. For example, the OSC has been granted authority to implement rules relating to fees in very narrow circumstances (establishing requirements in respect of post-receipt pricings (clause 143(1)16.iv); respecting sales charges, commissions or sales incentives in connection with investment funds (clause 143(1)31.ix); respecting fees payable by an issuer to an adviser (clause 143(1)32); and in prohibiting or restricting the payment of fees, commissions or compensation by commodity pools (clause 143(1)34)), but nowhere in connection with marketplace trading.

Defined Policy Rationale. We assume that the policy rationale for imposing this fee cap is to ensure that trade-through regulation will not induce an order to reroute to a marketplace where the resulting execution is “worse off” than if the order had executed on the marketplace originally intended.

Difficulty in measuring how to meet this policy rationale. Defining "worse off" in this context is not immediately obvious. We assume the CSA is looking at this solely from the short-term perspective of the party whose order is being routed (*i.e.*, looking at the purchase/sale price of the particular trade net of marketplace execution fees to be paid by the "liquidity taker") and not from the perspective of the contra party that posted the best bid or offer (the "liquidity provider"). However, any possible deterioration in the protection offered to liquidity providers to best bids and offers should always be factored into this consideration since less posted liquidity will in the longer term make liquidity takers worse off.

Even assuming we look only at the short-term perspective of the liquidity taker, it is not clear why the UMIR pricing increment should be used as the absolute amount of the fee cap.

For example, assume Marketplace A is offering (selling) XYZ at $10.00 and charges a 1.1 cent-per-share fee to execute, and assume Marketplace B is offering (selling) at $10.01 and charges a 0.3 cent-per-share fee to execute. Although Marketplace A offers the best price on XYZ at that moment in time, the CSA proposal would require that the order not be eligible for routing to Marketplace A because that marketplace's execution fee is greater than the UMIR pricing increment of 1 cent per share.

However, the more relevant comparison is between the differing net execution prices offered by marketplaces. So, in our example, the buyer would be paying a total of $10.011 per share to buy on Marketplace A and a total of $10.013 to buy on Marketplace B. Despite levying a significantly higher execution fee as compared to Marketplace B, Marketplace A is still offering the best net execution price. In fact, Marketplace A could increase its execution fee to 1.3 cents (*i.e.*, one UMIR pricing increment above Marketplace B's execution fee) and still match the net execution price offered by Marketplace B. By removing Marketplace A's $10.00 offer from the buyer's routing decision, the buyer would be made worse off.

So it would seem that rather than using the UMIR pricing increment as an absolute price cap, the more relevant measure is whether the *difference* between marketplaces' execution fees per share exceeds the amount of the UMIR pricing increment.

Determining "true" execution costs. To further complicate matters, marketplaces can (and do) levy other fees that are directly related to supporting the trading environment: monthly membership fees, connection fees, and testing fees, to name a few. If the CSA implements any form of execution fee cap, marketplaces may move to embed more of their execution costs within such fees, thereby creating the appearance of having lowered their "direct" execution fees. Will the CSA police these practices to ensure that the execution fees are reflecting the "true" costs of execution? Is CSA staff willing to become the final arbiter in this respect, much like the CRTC is within the telecommunications industry?

Competition already constrains execution fees. Whichever cap the CSA looks to employ (either the UMIR pricing increment as an absolute maximum, or ensuring that the "best priced" marketplace's "net execution fee" does not exceed other marketplaces' execution fees by the UMIR pricing increment), none of the protected Canadian marketplaces charge execution fees approaching either such maximum. The reason is obvious – competitive forces alone ensure optimal pricing. If a marketplace's "take" fees are materially higher than its competitors, it risks being last in dealers' routing tables and, in instances where it does not consistently offer the best price on stocks (*i.e.*, it only matches other marketplaces' prices rather than bettering them), it will receive only residual "take" flow. Taken together with the wording in proposed section 10.2(b) (*i.e*., a prohibition on differential pricing), competitive forces will constrain a marketplace's ability to increase its execution fees on orders routed to it in compliance of trade-through.

Risk of imposing a price cap. Finally, the risk of imposing any price cap, even one that appears to be well above the current level of marketplace execution fees, is that future market innovations may require increases in execution fees. For example, marketplaces are continually under pressure to innovate their service offering in terms of order types – some of which can approach the algorithmic complexity utilized by certain service bureaus and dealers. A price cap that seems reasonable today could render development of new algorithmic order types uneconomic.

Question 6: Should there be a prohibition against intentionally creating a "locked market"?

A locked market does not pose the same policy issues as does a crossed market. Inverted bids-asks cause three aspects of market harm: (a) they disincent liquidity provision to the extent that, by crossing a best bid/best offer on another market, delay is introduced in the time taken to execute against the best bid/best offer, (b) confusing price discovery for investors, and (c) systems difficulties for smart order routers and other trade-through monitoring systems. Locked markets do not suffer from the same problems: a zero bid-ask spread constitutes perfect price discovery (*i.e*., a single market-clearing price for a stock), and should pose no difficulty for order routers or other trade-through monitoring systems (although we recommend CSA staff canvassing the main order-router vendors in Canada to confirm our understanding).

The only policy objection to a dealer intentionally locking a market is a best execution concern – namely, a client has requested expeditious execution of a marketable order, but instead of immediately executing the order, the dealer opts to post the order on another marketplace and thereby increase the risk the client's order may not execute at the desired price. However, this best execution concern does not apply if the dealer is trading its own capital, or if the order is being entered by a DMA client or otherwise directed by the client. In these instances, preventing the dealer or client to direct their orders to a preferred execution venue is depriving them of investor choice.

The CSA staff may believe that prohibiting locked markets in all instances will improve liquidity, but regulators cannot create liquidity by forcing dealers and their clients to trade. Dealers and clients wishing to trade on cheaper execution venues, even ones that

offer liquidity-making rebates, will hold back on making their bids and offers and wait for the market to move away to permit them to post on their execution venue of choice.

General Comment - Routing-out by Marketplaces supporting Hidden Order Types

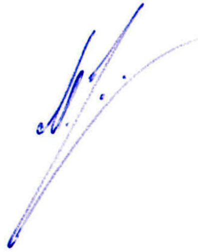
Finally, we also recommend that NI 23-101 restrict the ability of a marketplace to commingle order flow intended to be routed to best prices in away markets with hidden orders resting on that marketplace.

This principle has been established by IIROC under its UMIR Notice 08-0028, which states:

> If the protected marketplace offers a smart order router to those persons who have access to the marketplace, the order router should only take account of those orders on the protected marketplace which are included in the disclosed volume. In the view of IIROC, if an order router offered by a marketplace could take advantage of undisclosed volume on that marketplace when making a routing determination, such a router would have an unfair advantage over other routers that would not have access to information regarding the hidden orders.

Since the policy purpose behind trade-through protection is to protect and incent the posting of better-priced orders, it would be an abuse of a marketplace's trade-through obligation for it to host a hidden order type that pegs off the visible best bid/best offer and then intercept an order that ought to have gone to the visible order in the away market and reroute it to its own hidden orders.

Sincerely,



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