CNSX MARKETS INC.

BY EMAIL

January 10, 2011

Alberta Securities Commission
British Columbia Securities Commission
Manitoba Securities Commission
Autorité des marchés financiers
New Brunswick Securities Commission
Superintendent of Securities, Government Services of Newfoundland and Labrador
Superintendent of Securities, Department of Justice, Government of Northwest Territories
Nova Scotia Securities Commission
Superintendent of Securities, Nunavut
Ontario Securities Commission
Superintendent of Securities, Consumer, Corporate and Insurance Services, Office of the Attorney General, Prince Edward Island
Saskatchewan Financial Services Commission
Superintendent of Securities, Yukon

c/o John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
Suite 1900, Box 55
Toronto, Ontario M5H 3S8

- and -

M^e Anne-Marie Beaudoin
Directrice du secretariat
Autorité des marchés financiers
800, square Victoria, 22^e étage
C.P. 246, tour de la Bourse
Montréal, QC H4Z 1G3

- and -

James Twiss, Vice President, Market Regulation Policy and
Kevin McCoy, Senior Policy Analyst, Market Regulation Policy
Investment Industry Regulatory Organization of Canada
Suite 1600, 121 King Street West
Toronto, Ontario M5H 3T9

Dear Mesdames/Sirs:

RE: JOINT CSA/IIROC POSITION PAPER 23-405
DARK LIQUIDITY IN THE CANADIAN MARKET

We are pleased to respond to Position Paper 23-405 (the "position paper") and support the approach taken by the CSA and IIROC in providing these positions on dark liquidity as a basis for discussion and further policy development. CNSX Markets Inc. ("CNSX Markets") operates the Canadian National Stock Exchange and Pure Trading, two of the "lit" venues in Canada, and has long been a proponent of policy-making that reinforces the price discovery process, to help ensure the fairness and efficiency of our equity capital markets.

General Comments

Clear principles need to be established and reinforced to foster fair and efficient markets. One such principle in the equity markets is the need to ensure that there is a healthy pricing mechanism, supported by both pre- and post-trade transparency. Given the paramount importance of transparent pricing, the difficulty in establishing the point where price discovery begins to be harmed by non-transparent trading, and the cost of getting it wrong, we applaud the positions being proposed, which put these public policy principles ahead of individual advantages. The test for any type of dark trading, as we mentioned in our response to Joint CSA/IIROC Consultation Paper 23-404, should be whether the benefits to be provided by it outweigh the costs of withdrawing the orders from the price discovery mechanism. The test should not be, as some have suggested, whether the non-transparent trading has caused harm. Relying on a regulatory solution after the pricing mechanism has been demonstrably harmed will not deal with lost confidence in the fairness and integrity of the markets nor any related withdrawal of liquidity.

The positions under discussion are, at their core, a restatement of fundamental market structure principles. For such general principles, we do not believe that data analysis is applicable. Empirical analysis would be useful, however, in respect of the size chosen for minimum sized orders, and we encourage the CSA and IIROC to use the consolidated data in IIROC's position for that purpose.

Our comments on the positions taken by CSA and IIROC staff are set out below.

Minimum Size Exemption (for posting dark orders)

We understand the proposal of the CSA/IIROC to be that passive orders must be of minimum size to trade in the dark, but that smaller orders may execute against them, subject to price improvement. This means that any facility offering non-transparent trading must ensure that orders of less than the minimum size will not post, and that the only quotes requiring a pre-trade transparency exemption are therefore from minimum size orders ("MSOs").

In the various debates around dark trading, there has been one area of consensus: the need to accommodate the trading of large orders. There are market impact costs associated with trading such orders in public books that affect the sender as well as others in the markets at and around the time the orders are entered. Despite the advent of algorithms that slice large orders up, there are also algorithms that attempt to discover patterns and, as a result, large orders may still be disadvantaged to some degree, especially in relation to back office and clearing costs. However, we note that if this was a major impediment, the size of blocks in the upstairs market and dark pools should be increasing significantly, but it is not. In fact it is going in the opposite direction. To the extent analysis has been done (as discussed below) to arrive at an appropriate minimum size, we are supportive of the proposal to exempt MSOs from the transparency requirements.

Regarding appropriate size for MSOs, while we agree that the UMIR order exposure rule with its 50 standard trading units (or less if the value is more than $100,000) provides a floor, it was somewhat of a compromise. For establishing a size for MSOs it may be better to align them with the size of orders that are currently hard to trade in the visible markets. It may also be prudent to incorporate some flexibility to reflect varying levels of liquidity and to monitor subsequent trading practices in order to modify thresholds as required.

A survey of some of the standards used for designating "large" trades shows a range of options. At one end of the spectrum is the $25 million threshold for the now defunct "wide distribution" and, at the other end, the order exposure rule. In Canada there are few examples from dark pools to draw from, but we note that there was a size limit set at 25,000 initially set for trades on BlockBook, reduced to 10,000 after some operating experience. Under MiFID there are different thresholds, depending on liquidity, from a size of 500,000 euros for the most liquid to 50,000 euros for the least liquid. Finally, we note that ASIC has proposed to establish the following (for the purposes of pre-trade transparency exemptions, among others): 1) blocks at $1 million or more for highly liquid products and, for other products, $500,000 or more; and 2) for dark orders on lit markets or dark orders with price improvement, a minimum of $20,000.

Without the full data set, we can only estimate that the amount should be at least 10,000 shares with a minimum value of $100,000, as this has been a rule of thumb in the Canadian industry for the past few years. We suggest that an analysis of the consolidated 2010 trading data in IIROC's possession that would review and compare order and trade sizes in transparent and non-transparent trading, including the range of sizes traded in visible markets and range of sizes traded in blocks (whether in dark pools or upstairs), should help provide a better basis for setting the threshold.

Dark Orders and Price Improvement

On the basis that MSOs are an appropriate exception to the pre-trade transparency requirements because of their nature and the potential harm in not accommodating them, the only remaining question is whether they should be able to trade at the best bid/offer or be required to price improve. Since they may be clearly distinguished from other orders on the basis of their size, and there is general value in size discovery, we agree that MSOs should not be required to price improve.

There is an assumption in the position paper that dark pools/orders facilitate the sourcing of previously unavailable liquidity. This may or may not be true; it is one of the areas for which there is little data. While it is self-evident that there *is* an amount of dark liquidity that would be harmful to price discovery (the only question is how much) it is not self-evident that offering dark trading options brings out otherwise unavailable liquidity.

If, however, there is validity to the assumption that dark pools and orders facilitate interaction with otherwise unavailable liquidity and there is therefore a public good in allowing smaller orders to execute against large blocks non-transparently, we support the proposal that dark active orders that are not MSOs may only be executed where there is meaningful price improvement.

Execution Priority at the NBBO

We agree that lit orders should take priority over dark orders at the same price and we understand the practicalities of limiting the priority to a single marketplace. If size discovery is to be facilitated, allowing two dark MSOs to trade in priority to visible orders at the NBBO would be reasonable, so long as users of the marketplace understand fully that this is the case.

Practically, we question how applicable execution priority at the same price is for non-MSOs, since they must, to trade against an MSO, be awarded price improvement under the proposal.

Meaningful Price Improvement

We are interpreting "meaningful" in this case to apply not only to the recipient of the benefit, but also to whether it serves as an appropriate incentive to ensure the health of the pricing mechanism. Regardless, the point to be stressed is that, as the amount of the improvement shrinks, the balance of the utility to the trader versus the harm to the price discovery mechanism tips towards harm.

We support the CSA/IIROC proposal that price improvement should be at least the minimum trading increment. The order exposure rule exception based on price improvement was meant to create an economic disincentive for intermediaries seeking to divert orders from flowing to the public order book, not simply to provide a value-add to the client. If there is a persuasive argument that both goals can be achieved by an amount less than the current trading increment, then the trading increment should be reduced consistently for all marketplaces.

We do not understand, however, the argument that if the spread has been narrowed to the minimum, then a mid-point price improvement is appropriate. The minimum trading increment is either considered meaningful or not meaningful. It should not depend on the spread. More importantly, if the basis for allowing smaller orders to trade against larger orders in the dark is to allow them to interact with otherwise unavailable liquidity, then it is usually a moot point in a one cent spread environment, where availability of liquidity should typically not be a concern. By designating the mid-point to be "meaningful" it raises questions about whether best execution would require that all orders first seek such improvement, which is only available via non-transparent trading. The price improvement exemption from transparency should be used to address a deficiency, not to create an economic and, possibly, regulatory incentive to trade in dark pools or via dark order types at the expense of the broader public interest.

In summary, we view this position paper as a return to the fundamental principles of fair and efficient markets as opposed to innovation for the sake of innovation and we thank the CSA and IIROC for the considerable work that went into it.

Yours truly,

Ian Bandeen
CEO

cc: Richard Carleton, Vice-President – Corporate Development
Rob Cook, President
Mark Faulkner, Director – Listings & Regulation
Cindy Petlock, General Counsel & Corporate Secretary