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

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RE: Joint Canadian Securities Administrators / Investment Industry Regulatory Organization of Canada

Position Paper 23-405 – Dark Liquidity in the Canadian Market

BMO Nesbitt Burns Inc (BMO) welcomes the opportunity to provide comments on the Joint CSA/IIROC Position Paper 23-405 on Dark Liquidity in the Canadian Market.

BMO fully supports the CSA and IIROC objectives promoting competition and the continuing development of a market structure that promotes liquidity, transparency, price discovery, fairness and integrity. BMO appreciates the consultation process that the CSA and IIROC have undertaken to address key issues that impact market structure in Canada.

Following are BMO's specific responses to the issues addressed in the Position Paper:

Under what circumstances should Dark Pools or marketplaces that offer Dark Orders be exempted from the requirements of pre-trade transparency under NI 21-101?

Currently NI 21-101 section 7.1 (1) & (2) states:

> *A marketplace that displays orders of exchange-traded securities to a person or company shall provide accurate and timely information regarding orders for the exchange-traded securities displayed on the marketplace to an information processor as required by the information processor or, if there is no information processor, to an information vendor that meets the standards set by a regulation services provider.*
>
> *Subsection (1) does not apply if the marketplace only displays orders to its employees or to persons or companies retained by the marketplace to assist in the operation of the marketplace.*

We do not believe any Canadian trading venue offering dark order types are currently subject to this rule as they do not selectively disclose quotes to a subset of the marketplace. Consequently, we do not believe that dark pools or lit markets offering dark orders need an exemption to this rule.

We note the CSA and IIROC state in the Position Paper; *"in order to facilitate the price discovery process, orders entered on a marketplace should generally be transparent to the public".* We do not concur with this position and would caution against attempts to revise NI 21-101 to prescriptively mandate the use of transparent markets and order types when making liquidity instantly available to the marketplace. Dealers acting on behalf of institutional investors are subject to best execution obligations that mandate procedures towards ensuring the greatest potential for superior execution. Any attempt to overlay prescriptive regulation on top of this principals-based obligation will only restrict traders in their attempt to achieve best execution. While both prescriptive and principal-based regulations have their strengths and weaknesses, the combination of the two is almost certainly inferior to either style.

Further, we note that very limited academic research on the impact of dark trading on overall price discovery currently exists. As noted by Ian Domowitz's recent article "Are We Missing the Evidence in the Global Dark Pool Debate" (link), the research to date, while admittedly limited, is leaning towards the conclusion that increased activity on dark pools and via dark order types has not negatively impacted price discovery. Given that the regulatory impetus towards reducing options available to participants with respect to dark liquidity, we question the conclusion that increased dark pool activity will necessarily result in negative impacts to price discovery. In fact, the Canadian experience, with the evolution of a 'dark' market on close (MOC) facility which has dramatically reduced end of day volatility, demonstrates that dark markets can result in superior outcomes over lit markets in certain circumstances.

In the Position Paper, the CSA and IIROC note that a minimum size is *"consistent with the initial rationale for the introduction of Dark Pools and Dark Order types in general, which was to facilitate the execution of large orders and to enable more participants to interact with previously unavailable liquidity".* We suggest that the initial rationale for dark pools, which were first introduced to the U.S. marketplace in 1986, is of little importance in this argument. The marketplace of today bears little resemblance to the markets of 25 years ago. The introduction of electronic trading, move to penny ticks and the introduction of structured products have significantly changed the manner in which trade execution is accomplished. Further, we suggest that traders placing small, fully hidden orders are relinquishing the benefits of order protection and are receiving a lesser passive rebate or even paying for order placement. If we believe that these traders are acting in a rational manner, consistent with their best execution obligations, then they must believe that placing such orders in a visible manner will have market impact that will more than outweigh these benefits. We believe regulatory scrutiny should focus on the workings of our lit markets which make this type of order entry attractive, despite the negative implications, before eliminating a vital tool from the trader's toolbox.

Further, we believe that the CSA and IIROC belief that limiting fully dark order placement to orders meeting a minimum size will result in greater placement of small orders on visible venues may be misguided. While the average trade size of the fully hidden dark order types in Canada is relatively small, we believe that the order exposure rule – UMIR 8.1 – prevents such order placement for small orders. As such, we believe that the majority of small passive dark orders are children of larger orders. If a minimum order size is instituted, the traders (or algorithms) handling the larger order will be obligated to choose alternate order entry such as:

- placing larger dark orders risking greater adverse selection;
- moving the order to a visible book risking market signalling effects and inferior execution quality or;
- placing the order into a liquidity pinging (or pouncing) algorithm that is not instantly available to other market participants;

As these orders have clearly chosen to forgo the visible marketplace, we are not convinced that the imposition of minimum size restriction will result in the movement of these orders to visible markets. We caution that the advent of a minimum size rule may actually result in less achievable liquidity contrary to the stated policy goal.

Finally we note that Position Paper 23-405, as currently written, defines Dark Orders as *"an order on any marketplace which is entered with no pre-trade transparency"*. This

would mean that any active order that results in instant execution would need to meet a minimum size. This is also not practical. We believe serious consideration is required regarding the impact such a rule would have on the placement of FOK (or IOC) orders that are so important to intelligent smart order routing.

Should Dark Orders be required to provide meaningful price improvement over the NBBO, and under what circumstances?

Currently, the notion of priority is lost within the multiple marketplace environment. A visible order placed on Alpha at 9:00 am may go unfilled all day while similar orders placed hours later on Chi-X get filled. As such, we don't see any reason to prevent fully dark orders from trading ahead of fully or partially visible orders at the same price. While some may argue the need for a single consolidated book that returns time priority to the market, we believe this will create more issues than it solves. In the interim, given the regulatory objective of fair competition between all trading venues, we would suggest that if a bid on one marketplace can notionally "jump" the time priority queue, then a bid on another marketplace should be able to do the same.

Should visible (lit) orders have priority over Dark Orders at the same price on the same marketplace?

We agree that visible orders should execute on a visible book before dark orders on the same marketplace. We have seen significant erosion in the value of visible order placement in the last 24 months and allowing dark orders to execute ahead of visible orders on the same book would only amplify this erosion. With that in mind, we note that consideration is required with respect to the definition of "same marketplace".

Two of the visible Canadian marketplaces currently have filed applications to create a second order book that is, at least from a regulatory perspective, separate from their existing order book. This is consistent with the U.S. marketplace where all large visible markets have two or more order books. If a trading venue is allowed to create a second (or third or fourth) unique order book that purely contains dark orders such that is circumvents this rule, we will have achieved nothing. At the same time we are concerned that related books interplay with each other in a way that is inconsistent with how they interplay with non-related books. We would not want a market venue SOR to be aware of hidden orders on two related but unique order books, as this creates unfair competition between markets. This situation is contra to the objective of fair competition between markets. In order to clearly determine the value of this rule we require clarification of the intended regulatory approach to marketplace operators with two or more distinct order books.

Despite this, we believe that visible liquidity should trade ahead of dark liquidity on the same venue. We note one significant exception. We believe that allowing marketplaces to create liquidity pools that allow same dealer dark orders to trade ahead of other visible orders will dis-incent larger dealers from creating their own internalization systems which could result in less transparency and the reduction of desk orders that are exposed in an instantly transactable manner (23-405 clearly states at the start of the Paper that it will be dealing with the issue of "broker preferencing" at a later date - we find it difficult to conceive of dark pool and dark order regulations that do not address broker

internalization systems). We believe that broker internalization is a natural defence mechanism used by brokers to limit order gaming. As a dealer we are only able to control the order flow of one market participant and therefore we are positively disposed to trade with our own clients first for a number of reasons. Critics have argued that such systems will be used by bank-owned dealers to the benefit of their proprietary trading strategies. This concern could easily be addressed by allowing such internalization to occur only when the passive side is an agency order however we would be concerned about the potential signalling this might introduce.

We are of the belief that the benefit of allowing a dealer with a large order on a relatively illiquid stock to post a passive dark order and capture internal retail, DMA and algorithmic order flow without the constant need to visibly peg to the bid (offer) and expose the order to unwanted gaming will result in reduced market impact of larger orders. This is consistent with the goal of efficient and economical trade execution.

What is a "meaningful" level of price improvement?

As we have stated above, we believe that dark orders should be able to execute at the bid (offer) and as such don't believe in the notion of "meaningful" price improvement.

We thank the CSA and IIROC for allowing us to comment on these very important market structure matters and look forward to contributing to the ongoing process. We urge consideration of the incentives currently in place for traders to place small orders in a fully hidden fashion – and address these, rather than regulate order placement strategy. We believe that the best execution obligation already mandates traders to place orders in a manner that is consistent with their end clients' goals, and where traders are placing small orders into dark pools, they must be of the view that such order placement is beneficial. As we currently aren't aware of any research that demonstrates such order placement negatively impacts the price discovery process, we are not in favour of a minimum order size for dark order placement.

Sincerely,

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