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Liquidnet Canada Inc.
200 Bay Street Suite 3400
Toronto, ON M5J2J1

January 10, 2011

By e-mail

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
E-mail: jstevenson@osc.gov.on.ca

and

Me Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, tour de la Bourse
Montréal (Québec) H4Z 1G3
e-mail:consultation-en-cours@lautorite.qc.ca

James Twiss – Vice President, Market Regulation Policy
Kevin McCoy – Senior Policy Analyst, Market Regulation Policy
Investment Industry Regulatory Organization of Canada
Suite 1600

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121 King Street West
Toronto, Ontario
M5H 3T9
Email: jtwiss@iiroc.ca/kmccoy@iiroc.ca

Re: Liquidnet Canada Inc. - Comment Letter on IIROC and CSA Consultation Paper 23-405

Ladies and Gentlemen,

Liquidnet Canada Inc. (Liquidnet) appreciates the opportunity to submit this comment letter on "Position Paper 23-405, Dark Liquidity in the Canadian Market," (the Position Paper) jointly issued by the Canadian Securities Administrators (the CSA) and the Investment Industry Regulatory Organization of Canada (IIROC).

The Position Paper presents the views of the CSA and IIROC staff on four issues relating to dark liquidity in the Canadian market. We present our views on each of these four issues.

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Liquidnet, together with its global affiliates, operate block crossing systems for institutional investors worldwide, and Liquidnet is registered as a marketplace operator in Canada. Our subscribers make extensive use of dark orders.

We are providing as **Exhibit 1** comments from market participants globally on the benefits of block crossing systems. The cost savings provided by block crossing systems for executing large block orders are passed on to the hundreds of millions of investors globally who invest through mutual funds, retirement funds and similar pooled investment vehicles. Regulations that impede the ability of institutional traders to execute block orders efficiently will result in higher trading costs for institutions and lower investment returns for the millions of Canadians, whose savings are invested through mutual funds, through government or private pension funds and other similar pooled investment vehicles.

<u>Issue 1: Exemption from pre-trade transparency</u>

Staff view: The only exemption to pre-trade transparency should be for orders that meet a minimum size threshold

Most of the buy-side traders with whom we have spoken do not support a minimum size threshold, as they would like to retain flexibility to execute block orders in smaller increments. We agree with this position as we believe that market forces promote the display of liquidity and that regulatory mandates in this area are not required. We also believe, more generally, that competition and innovation by marketplaces and market participants leads to improved products and services for customers

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If the CSA and IIROC move forward with their proposal to require a minimum size threshold, we believe that 50 board lots is a reasonable threshold, and one that is consistent with historical regulatory requirements in Canada relating to order display. For most stocks, 50 trading units equates to 5,000 shares.

We agree with the recommendation of the CSA and IIROC not to set the threshold at an amount that is higher than 50 board lots. With the increasing sophistication of order anticipation strategies used by high-frequency traders and other market intermediaries (we will refer to them as "short-term traders"), blocks or 50 board lots or higher are susceptible to detection by short-term traders and resulting market impact.

The TABB Group, a firm with expertise in institutional trading and market structure, wrote as follows in a recent research report:

> "In fact, there are numerous executions that fall between 2,000-9,000 shares. This subcategory of blocks, sometimes referred [to] as the 'demi-block', has grown over the past few years. These prints are significantly larger than the average 300 share print found on most liquidity venues, but smaller than the traditional over 10,000 share blocks. Even some volume from traditional block dark pools have fall[en] into this segment. Trades within this category can have just as much market impact as those at the 50,000 share range.
>
> For instance, in less-liquid markets, lower trading volumes are required for an order to take on a block-like risk profile. Trades in an illiquid security tend to be a large percentage of the average daily volume. This means that although typical share and dollar value definitions may not apply, sub-block executions become just as visible as conventional blocks. Participants in our study reinforced this concept by noting that venues specializing in blocks are more likely to carry a match in the most illiquid securities."[1]

An institution has an important interest in protecting the confidentiality of an order that is 50 board lots or more. In many cases, an institutional trader seeks to protect his or her order information from short-term traders who can take advantage of that information to the detriment of the institution and its customers. Liquidnet appreciates the recognition by the regulators of the institutional trader's interest in protecting the confidentiality of his or her customer order information. Liquidnet supports the regulatory proposal to exempt orders of 50 board lots or more from pre-trade transparency.

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Liquidnet's understanding is that, in setting a threshold of 50 board lots, the CSA and IIROC are attempting to differentiate institutional orders from other orders in the market. Liquidnet believes that 50 board lots is a sensible threshold for defining an institutional order. A more precise approach might involve setting tiered thresholds based on ADV or market cap, but precision must be balanced against the advantage of having a simple and straightforward threshold of 50 board lots.

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[1] Matt Simon, Tabb Group, "US Equity Trading 2010/2011: Outflows, Outrage, and Balance," pp. 40-41.

With respect to orders of less than 50 board lots, Liquidnet's position is that even if an order is less than 50 board lots, an institution might still want to execute that order without public display. Liquidnet believes that each institutional trader should have the right to determine how to execute an order, including whether or not to display the order. Ultimately, we should rely on the institutional trader to make the decision that is most appropriate for the institution's customers, as these customers represent millions of Canadian citizens.

We note that Liquidnet typically does not handle orders of less than 50 trading units, so requiring pre-trade transparency for orders of less than 50 trading units would not impact our business. However, we encourage the CSA and IIROC to carefully consider the views of institutional customers, and we defer to the consensus views of the institutional investors on this point.

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We support the view expressed in the Policy Paper that, "... if a Dark Order meeting the minimum size threshold receives a partial fill which results in the remaining balance being less than the size threshold, that order should be able to continue to remain dark until cancelled or fully executed."[2]

We support this view for several reasons, including the following:

- ***Mitigate against market impact for subsequent block orders in the same security.*** In many cases, an institution will have more to trade in a name after its first block order is executed in full. Having to expose the residual portion of the original block order could adversely impact execution quality for subsequent block orders in the same name.

- ***Avoid unnecessary double ticket charges.*** In cases where a block crossing system could not execute a non-block residual portion of a block order, an institution would have to use a second broker to execute the residual portion of the order, resulting in higher order ticket charges.

- ***Avoid necessity for exposing an order to multiple brokers.*** Institutional traders often seek to handle an order through one broker or venue to minimize the potential market impact costs of exposing an order to more than one broker or venue. The CSA and IIROC position would facilitate this approach.

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Read literally, this proposal could prohibit immediate-or-cancel (IOC) orders since IOC orders are not displayed. We do not believe this is the intention of the regulators. We recommend for the regulators to clarify that IOC and active orders would not be subject to a pre-trade transparency obligation unless and until, in the case of active orders, they are posted on a marketplace.

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[2] Policy Paper, (2010) 33 OSCB 10770.

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Issue 2: Executing at the NBBO

Staff view: Two Dark Orders meeting the minimum size exemption should be able to execute at the NBBO. Meaningful price improvement should be required in all other circumstances, including all executions with orders not specifically marked in a manner indicating they are utilizing the minimum size exemption.

Liquidnet agrees that two dark orders meeting the minimum size exemption should be able to execute at the NBBO. We refer to dark orders that meet the minimum size exemption as "qualifying orders". Allowing qualifying orders to trade at the NBBO is consistent with the current practice in the upstairs market. We believe this practice is beneficial for institutional investors.

We also would support a look-back interpretation, similar to the one adopted by the Securities and Exchange Commission in the U.S.,[3] that would allow two negotiating institutions with qualifying orders to execute a trade outside the NBBO where the bid or offer of the submitting institution was within the NBBO at the time of order submission. Under this interpretation, if an institution submits a negotiated bid or offer that is within the NBBO at the time it is submitted, and the receiving party (i.e., the contra) subsequently accepts that bid or offer, but by the time of acceptance the NBBO has moved outside the submitted bid, the trade would be permitted. It would be a condition for this interpretation that the bid or offer was accepted by the contra within a short period of time after submission by the first party (for example, 20 seconds, as provided in the U.S. interpretation, or a shorter period, such as 10 seconds). The policy justification for this interpretation is that the intent of the institutions is to trade within the spread and the reality of sub-second quote flickering has made this challenging for negotiated block transactions. This interpretation has been helpful for our customers in the U.S., and we believe it also would be beneficial for our customers in Canada.

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We also agree with the proposal to allow non-qualifying orders to execute without public display, subject to providing meaningful price improvement. Liquidnet currently executes 88% of our trades in Canadian securities at the mid-point,[4] providing meaningful price improvement to both parties to the trade. This proposal would allow institutional and retail orders to interact with each other at the mid-point, providing meaningful price improvement to both parties.

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One question that arises with respect to internalization of orders by dealers is whether appropriate disclosure of execution quality is provided to investors. As a potential alternative to setting a meaningful price improvement standard for dark executions that are below the proposed minimum size threshold, the regulators could require that brokers interacting with retail customers provide enhanced disclosure of execution quality to their customers so customers can

[3] Division of Trading and Markets, Responses to Frequently Asked Questions Concerning Rule 611 and Rule 610 of Regulation NMS, April 4, 2008 Update (last updated on June 8, 2007), http://www.sec.gov/divisions/marketreg/nmsfaq610-11.htm (accessed January 10, 2011).

[4] Liquidnet Canada data, Q3 2010.

make more informed decisions about their orders. For example, there could be a requirement for brokers to disclose the following information on the confirmation for every transaction:

- Time of order receipt
- NBBO at the time of order receipt
- Time of order execution
- NBBO at the time of order execution
- Execution price
- Price improvement (or dis-improvement) per share relative to the NBBO at the time of order receipt
- Price improvement (or dis-improvement) percentage, computed as follows:
    - In the case of a customer sale, (i) execution price minus the national best bid at the time of order receipt, divided by (ii) ½ of the NBBO spread at the time of order receipt.
    - In the case of a customer purchase, (i) the national best offer at the time of order receipt minus the execution price, divided by (ii) ½ of the NBBO spread at the time of order receipt.

Issue 3: Priority of visible and non-visible orders on a marketplace

Staff view: Visible orders on a marketplace should execute before Dark Orders at the same price on the same marketplace. However, an exception could be made where two Dark Orders meeting the minimum size threshold can be executed at that price.

Liquidnet believes that each marketplace should have the right to determine its own priority rules, as long as clear and prominent disclosure of those rules is made available to all marketplace participants. For example, a marketplace that focuses on efficient execution of large block orders should have the right to prioritize execution of block orders. In addition, a different marketplace which uses market makers for guaranteed liquidity provision may also want to offer incentives based on priority, as some Canadian marketplaces have in the past.

Our position on this issue is based on our belief that different marketplaces serve different functions, and there is no "one size fits all" marketplace. For example, Liquidnet's average negotiated execution size for Canadian securities is 67,905 shares.[5] This is 130 times larger than the average execution size on the Toronto Stock Exchange, which is 522 shares.[6] It is clear from this data that different marketplaces serve different functions. Rules that restrict the flexibility of marketplaces to address the needs of specific groups of marketplace participants can be detrimental to those participants. In the case of Liquidnet, our participants are the mutual funds and pension plans that trade on behalf of most Canadian citizens, and rules that restrict our flexibility to serve those customers would mean higher trading costs and lower investment returns for most Canadian citizens.

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[5] TSX data Q3_ 2010 –, http://www.tmx.com/en/pdf/month_stats/TradingStats_Jul10.pdf, http://www.tmx.com/en/pdf/month_stats/TradingStats_Aug10.pdf, http://www.tmx.com/en/pdf/month_stats/TradingStats_Sep10.pdf (accessed January 10, 2011). This number includes off-exchange matched crosses, which are not differentiated in TSX reporting.

[6] Liquidnet Canada data, Q3 2010.

This specific proposal would not impact our business. However, as a general matter, regulators must take into account the importance of not unduly restricting innovation in the provision of trading services by marketplaces.

Issue 4: Definition of meaningful price improvement

Staff view: Meaningful price improvement means that the price is improved over the NBBO by a minimum of one trading increment as defined in UMIR, except where the NBBO spread is already at the minimum tick. In this case, meaningful price improvement would be at the mid-point of the spread

We agree with the proposed definition of meaningful price improvement. Liquidnet executes 88% of our trades at the mid-point of the national best bid and offer,[7] which means 100% price improvement for both sides to the trade. These trades would meet the standard of meaningful price improvement.

We further agree that where the NBBO spread is one tick, meaningful price improvement would be at the mid-point of the spread. This is because executing at the mid-point of the spread means 100% price improvement.

Finally, if the CSA and IIROC determine that a standard for meaningful price improvement should be established, we agree that the standard should be clearly defined within the regulations.

[7] Liquidnet Canada data, Q3 2010.

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Conclusion

Our general view is that competition and innovation lead to improved products and services for customers, and that mandates for pre-trade transparency are not necessary. That being said, from a business standpoint, we have no issues with any of the CSA and IIROC proposals, as they contain appropriate exceptions that would allow us to continue to facilitate block trades for our institutional customers.

The institutions that handle orders of 50 board lots or more invest and trade on behalf of the significant majority of Canadian citizens. It is important that we provide appropriate flexibility for institutional traders that handle these types of orders, and for marketplaces that execute these types of orders, to ensure that we minimize trading costs, and maximize investment returns, for millions of Canadian citizens.

Forcing institutions to display block order information when it is not in their economic interest to do so will mean higher profits for high-frequency traders and other market intermediaries and lower investment returns for millions of Canadian citizens. Conversely, providing flexibility for institutional traders to seek the most efficient means for executing their block orders will mean reduced trading costs, and higher investment returns, for millions of Canadian citizens.

We appreciate the opportunity to comment on the Position Paper.

Very truly yours,

Robert Young
President and CEO

Sophia Lee
General Counsel

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Exhibit 1

The benefits of systems that facilitate block trading on behalf of long-term investors - comments from institutional investors and industry experts

Systems that facilitate the execution of institutional block orders with reduced market impact reduce trading costs for institutions. The cost savings achieved by institutions through these systems are passed on to hundreds of millions of individual investors globally who invest for the long-term through mutual funds and other collective investment vehicles.

This document presents written public statements from buy-side institutions,[1] buy-side trade groups, regulators and industry experts on the value of systems that facilitate execution of institutional block orders on behalf of long-term investors.

This category of systems include systems like Liquidnet that focus on execution of block orders. It also includes broker-operated dark pools, sometimes referred to as "broker crossing networks." Many of these systems execute block and non-block orders. In this Exhibit, we focus specifically on the value of these types of systems for executing institutional block orders.

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As emphasized by the U.S. Securities and Exchange Commission in its 2010 "Concept Release on Equity Market Structure", the protection of long-term investors is a top priority:

> "In assessing the performance of the current equity market structure and whether it is meeting the relevant Exchange Act objectives, the Commission is particularly focused on the interests of long-term investors. These are the market participants who provide capital investment and are willing to accept the risk of ownership in listed companies for an extended period of time.
>
> . . . .
>
> Given the difference in time horizons . . . the trading needs of long-term investors and short-term professional traders often may diverge. Professional trading is a highly competitive endeavor in which success or failure may depend on employing the fastest systems and the most sophisticated trading strategies that require major expenditures to develop and operate. Such systems and strategies may not be particularly useful, in contrast, for investors seeking to establish a long-term position rather than profit from fleeting price movements. Where the interests of long-term investors and short-term professional traders

[1] Institutions that invest and trade on behalf of mutual funds and other long-term investors are often referred to as "buy-side institutions".

> diverge, the Commission repeatedly has emphasized that its duty is to uphold the interests of long-term investors."[2]

This document is broken out into five sections – Europe; U.S.; Canada; Australia; and IOSCO.

Europe

In November 2008, the Committee of European Securities Regulators (CESR) published a "Call for evidence on the impact of MiFID on secondary markets functioning," seeking feedback from market participants in Europe on the impact of the Markets in Financial Instruments Directive.[3] As part of this process, CESR solicited feedback from market participants on various topics relating to the secondary markets, including dark pools.

The significant majority of responding parties, including many buy-side market participants who invest on behalf of tens of millions of European citizens, identified the benefits of dark pools for executing large orders.

The European Banking Federation, whose membership includes approximately 5,000 European banks,[4] wrote:

> "Dark pools have an important role in that they allow the execution of large orders without creating a market impact. Pre-trade transparency requirements for such types of orders would otherwise lead to artificial price distortion. I.e., without the possibility of trading in dark pools the investor would be forced to execute the transaction in tranches."[5]

The Association of British Insurers, the voice of the insurance and investment industry with members constituting over 90 per cent of the insurance market in the UK and twenty per cent across the EU, wrote:

> "Our members believe there are benefits to the dark pools of liquidity, namely the reduction of market impact as CESR highlights. Portfolio managers often trade in large sizes so minimising market impact – and thus reducing the cost of trading - is of great importance to them."[6]

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[2] Securities Exchange Act Release No. 61358 (January 14, 2010) 75 FR 3594 (January 21, 2010), http://sec.gov/rules/concept/2010/34-61358fr.pdf (accessed January 10, 2011), pp. 33-34 ("SEC Concept Release").
[3] Ref. CESR/08-872, 3 November 2008.
[4] http://www.ebf-fbe.eu/ (accessed January 10, 2011).
[5] "EBF Response to CESR Call for Evidence on the Impact of MiFID on Secondary Markets Functioning", 9 January 2009, http://www.esma.europa.eu/popup_responses.php?id=4425 (accessed January 10, 2011).
[6] "Call for evidence on the impact of MiFID on secondary market functioning - The ABI's Response to CESR 08-872", January 2009, http://www.esma.europa.eu/popup_responses.php?id=4436 (accessed January 10, 2011).

The Investment Management Association, the trade body for the UK's asset management industry,[7] wrote:

> "IMA members believe that dark pools are helpful in trading large blocks of stock particularly in minimising market impact and in achieving best execution."[8]

NYSE Euronext wrote:

> "The trend towards smaller execution sizes in central 'lit' order books boosts the demand foralternative trading models. Dark pools respond to this demand by offering the industry a place fortrading large orders with minimal impact on prices and allow professional investors to searchcounterparty. Therefore, we strongly believe that there are benefits in offering servicescomplementary to order books."[9]

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In 2010 CESR published three papers soliciting comments on various issues relating to the Markets in Financial Instruments Directive.[10]

In response to the CESR consultation papers, buy-side firms and buy-side industry groups were uniform in their support for systems that facilitate execution of block orders.

The Association of British Insurers wrote:

> "[F]or investors trading in size, total transparency is not always a panacea. Some kind of hidden liquidity has always existed as is the case now with dark pools and broker crossing networks.... The trade size has decreased and our members sometimes have to balance the trade-off between total transparency when using regulated markets open to high frequency traders and others, and

[7] www.investmentuk.org (accessed January 10, 2011).
[8] "Call for Evidence on the Impact of MiFID on Secondary Market Functioning", 8 January 2009.
[9] "Comments from NYSE Euronext in Response to CESR's Call for Evidence on the Impact of MiFID on Secondary Markets Functioning (CESR/08-872)", January 2009, http://www.esma.europa.eu/popup_responses.php?id=4464 (accessed January 10, 2011).
[10] "CESR Technical advice to the European Commission in the context of the MiFID review – Transaction Reporting - CESR 10-292", 13 April 2010, http://www.cesr.eu/data/document/10_796.pdf (accessed January 10, 2011). "CESR Technical advice to the European Commission in the context of the MiFID review – Equity Markets - CESR 10-394", 13 April 2010, http://www.cesr.eu/data/document/10_975.pdf (accessed January 10, 2011). "CESR Technical advice to the European Commission in the context of the MiFID review – Investor protection and Intermediaries – CESR 10-417", 13 April 2010, http://www.cesr.eu/popup2.php?id=6544 (accessed January 10, 2011).

decreased market impact and liquidity for large orders when trading over the counter, whether in dark pools or crossing networks."[11]

The Association of British Insurers wrote further:

> "Institutional investors such as our members, trading on behalf of their clients who are policyholders or pensioners, are significant users of dark pools. They do this because they believe that is where they can achieve best execution for some orders. That, in turn, is because being able to transact in size away from lit markets reduces the market impact and therefore transaction costs."[12]

Fidelity International Limited (FIL) wrote:

> "Dark venues provide significant benefits to institutional clients' whose flow tends to be large in size. Benefits include reduced market impact, lower information leakage and larger fills than on traditional public and light alternatives."[13]

FIL further pointed out:

> "Institutional investors benefit from broker crossing networks / dark pools and we are opposed to any signaling from them to the lit market that may increase our cost to trade."[14]

Wellington Management Company wrote:

> "As a fund manager, we routinely use broker crossing networks (BCNs) for large orders to avoid market impact that might arise if other market participants were to trade ahead of our orders. We generally instruct firms not to display our orders where such non-display is judged to benefit execution quality."[15]

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Other market participants concur with the views of the buy-side. Steve Grob, Director of Group Strategy at Fidessa (London), a technology vendor, remarks in a Finextra article:

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[11] ABI Response to the CESR Consultation on Equity Markets, http://www.esma.europa.eu/popup_responses.php?id=5538 (accessed January 10, 2011), p. 2 ("ABI 2010 Letter").

[12] ABI 2000 Letter, p. 11.

[13] FIL response to CESR's Consultation Paper on Technical Advice to the European Commission in the context of the MiFID Review – Equity Markets, http://www.esma.europa.eu/popup_responses.php?id=5616 (accessed January 10, 2011), p. 1 ("FIL Letter").

[14] FIL Letter, p. 7.

[15] Wellington Management Company Letter to Committee of European Securities Regulators, CESR Technical Advice to the European Commission in the Context of the MiFID Review – Equity Markets, Ref: CESR/10-394 (May 31, 2010), http://www.esma.europa.eu/popup_responses.php?id=5512 (accessed January 10, 2011), p. 4.

"The concept that dark pools are 'always bad' is naive on a number of levels. Firstly, the term 'dark pools' covers a whole host of different non-lit order matching services. These range from buy-side crossing networks, through discretionary broker services, to dark books operated by exchanges and MTFs. These different pools offer a range of different services to professional investors so that they can minimise market impact and achieve the best possible outcome for their orders. Secondly, the concept of trading off-exchange – or 'in the dark' – has existed for as long as the exchanges themselves. Many of the broker dark pools are simply automated versions of their traditional 'upstairs' activity that seek to deliver on the brokers' fiduciary duty to get the best possible outcome for their clients. For many pension and traditional long-only funds the idea that they can, or should, trade the huge blocks they do on lit markets is bizarre. Take Liquidnet, for example, which prints average trade sizes that are hundreds or thousands of times larger than trades in the same stocks on lit markets."[16]

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Buy-side traders in Europe and the US have specifically identified Liquidnet as an example of a trading venue that reduces execution costs for their block orders.

Kevin Chapman, Managing Director of Nicholas-Applegate Capital Management, stated:

"I'd rather see the traders using aggregators like. . . Liquidnet. . . because that would tell me they're sourcing their own liquidity and trying to get a good execution."[17]

Kristian West, Head of Equity Trading, JP Morgan Investment Management, stated:

"Overall, we use a relatively small subset of firms to access the fragmented pools of liquidity. These are platforms we trust. For example, we have access to Liquidnet and that for us is an opportunity to cross liquidity 'upstairs' before it hits the market."[18]

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Kay Swinburne, an MEP from Wales, the European Conservatives and Reformists (ECR) Group's Coordinator on the Economics and Monetary Committee in the European Parliament and the ECR Group's Coordinator on the Special Committee on the Financial, Economic and Social Crisis,

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[16] Steve Grob, "Brussel Spouts", *Finextra*, November 26, 2010, http://www.finextra.com/community/fullblog.aspx?id=4755 (accessed January 10, 2011).
[17] "TCA plugs you into the front office", *Buy-Side Technology*, November 1, 2009, http://db.riskwaters.com/public/showPage.html?validate=0&page=bst_login&url=%2Fpublic%2FshowPage.html%3Fpage%3D870805 (accessed January 10, 2011).
[18] "What doesn't kill you . . .", *The Trade*, December 1, 2009, http://www.thetradenews.com/what-doesn%E2%80%99t-kill-you-%E2%80%A6 (accessed January 10, 2011).

recently commented favorably on Liquidnet and other systems that seek to address the specific needs of long-term investors:

> "I have been watching the development of NASDAQ OMX's latest US equity platform that has a minimum size order threshold, rewarding size not frequency of trade, as well as the progress of buy-side only MTFs like Liquidnet that choose to build in latency to their systems in order to filter participants wishing to access their systems.
>
> Both of these methods have been discussed by regulators on both sides of the Atlantic, yet thankfully, no one has looked to impose blanket solutions to entire markets. The more market solutions and options for investors that spring up to fill the gap between the perceived weaknesses in the market and its ability to serve its primary purpose, the less regulation we will need to come up with to fill the void."

In this passage, MEP Swinburne suggests that regulators should look favorably upon "market solutions" like Liquidnet that seek to address specific problems in the market. Liquidnet provides a market solution to address the challenges faced by institutions in executing block orders on behalf of long-term investors.

United States

Mary L. Schapiro, Chairman of the U.S. Securities and Exchange Commission, stated on December 8, 2010 in testimony before two U.S. Senate sub-committees:

> "Many institutional investors value the opportunity to trade in dark venues because of a fear that trading in the public markets in large sizes will cause prices to run away from them. We will explore all aspects of this issue to reach a balanced conclusion. At the end of the day, investors of all types must have confidence that our market structure provides high-quality price discovery and the tools they need to meet their investment objectives in a fair and efficient manner."[19]

[19] Testimony by Mary L. Schapiro, Chairman of the U.S. Securities and Exchange Commission, on December 8, 2010 before the Subcommittee on Securities, Insurance, and Investment of the United States Senate Committee on Banking, Housing, and Urban Affairs and the United States Senate Permanent Subcommittee on Investigations in recent testimony on U.S. Equity Market Structure by the U.S. Securities and Exchange Commission, http://www.sec.gov/news/testimony/2010/ts120810mls.htm (accessed January 10, 2011).

In its "Concept Release on Equity Market Structure" issued in 2010 (the SEC Concept Release), the U.S. Securities and Exchange Commission (SEC) identified the benefits of systems that facilitate the execution of large institutional orders.[20] The SEC wrote:

> "In general, dark pools offer trading services to institutional investors and others that seek to execute large trading interest in a manner that will minimize the movement of prices against the trading interest and thereby reduce trading costs."[21]

The SEC wrote further:

> "An important objective of many dark pools is to offer institutional investors an efficient venue in which to trade in large size (often by splitting a large parent order into many child orders) with minimized market impact."[22]

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Robert Greifeld, Chief Executive Officer of Nasdaq, the world's largest electronic stock exchange, stated as follows in response to a question on dark pools during a recent television interview with Steve Forbes:

> "... a dark pool that's doing a large size, that's clearly a value added, because we know today that if you come into the lit market with larger size, you have a disproportionate impact on the lit market."[23]

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In their comment letters on the SEC Concept Release, buy-side institutions expressed similar views regarding the value of systems that facilitate execution of block orders.

According to the Investment Company Institute, the national association of U.S. investment companies whose members serve almost 90 million shareholders,

> "Funds have long been significant users of undisplayed liquidity and the trading venues that provide such liquidity. These venues provide a mechanism for transactions to interact without displaying the full scale of a fund's trading interest, thereby lessening the cost of implementing trading ideas and mitigating the risk of information leakage. These venues also allow funds to

[20] SEC Concept Release.
[21] SEC Concept Release, p. 18.
[22] SEC Concept Release, p. 68.
[23] "Interview with Robert Greifeld, Intelligent Investing with Steve Forbes," December 3, 2010, http://www.forbes.com/2010/12/03/greifeld-nasdaq-psx-intelligent-investing-video.html?partner=daily_newsletter (accessed December 21, 2010).

avoid transacting with market participants who seek to profit from the impact of the public display of large orders to the detriment of funds and their shareholders. As we have stated in several letters to the Commission, the confidentiality of information regarding fund trades is of significant importance to Institute members. Any premature or improper disclosure of this information can lead to front-running of a funds' trades, adversely impacting the price of the stock that the fund is buying or selling.

. . . .

We therefore believe it is imperative that venues trading undisplayed liquidity remain available to funds. We would be concerned if any Commission proposal impeded funds as they trade securities in venues providing undisplayed liquidity, whether it be through trading large blocks or through other trading methods."[24]

The Investment Adviser Association, a not-for-profit association that represents the interests of investment adviser firms that are registered with the SEC, wrote:

> "In this regard, dark pools have been critically important in assisting investment managers to minimize market impact costs. These dark pools have permitted large orders to be executed without publicly disseminating the investment manager's trading interests and strategy. We agree with many of the comments to the Commission's proposal to regulate non-public trading interest that trading venues providing undisplayed liquidity are important trading centers for asset managers that seek to minimize market impact (both implicit and explicit) costs for their client trades."[25]

The Vanguard Group, Inc. wrote,

> "Vanguard believes large block crossing networks that match large institutional clients at prices between the NBBO play a valuable role in today's markets."[26]

T. Rowe Price Associates, Inc. wrote,

> "Almost all institutional investors, including T. Rowe Price, utilize trading venues that allow access to undisplayed liquidity. T. Rowe Price strongly takes the position that these 'dark pools' are a vital tool for institutional investors with large blocks of stock to buy and sell. Institutional investors highly value the

[24] Letter dated April 21, 2010 from Karrie McMillan, General Counsel, Investment Company Institute, http://sec.gov/comments/s7-02-10/s70210.shtml (accessed January 10, 2011), pp. 12-13.
[25] Letter dated April 20, 2010 from Jennifer S. Choi, Assistant General Counsel, Investment Adviser Association, http://sec.gov/comments/s7-02-10/s70210.shtml (accessed January 10, 2011), p. 2.
[26] Letter dated April 21, 2010 from George U. Sauter, Managing Director and Chief Investment Officer, The Vanguard Group, Inc., http://sec.gov/comments/s7-02-10/s70210.shtml (accessed January 10, 2011), p. 5.

specialized size discovery mechanisms that bring large buyers and sellers in the same stock together anonymously and to facilitate a trade between them. We would not be supportive of any regulation that negatively impacts our ability to access these pools of undisplayed liquidity."[27]

The Security Traders Association of New York, Inc., the largest affiliate of the Security Traders Association, a professional association of buy-side and sell-side traders, wrote:

> "As the Commission has acknowledged there is a need for targeted size discovery mechanisms that enable investors to trade efficiently in size orders and undisplayed liquidity is often used by those wishing to avoid adverse market impact when executing their trades.
>
> . . . .
>
> We do not believe that the existence of undisplayed liquidity has materially harmed price discovery. Despite the existence of ATSs and dark pools displayed markets continue to prosper. The best measure of price discovery is quoted spreads. If there is not enough incentive to post limit orders, the result would be a widening of quoted spreads because intermediaries would charge more to post limit orders. But all the data shows that quoted spreads are narrowing. The narrowing of quoted spreads directly contradicts the assertion that dark pools or internalization are negatively affecting price discovery. The aggregate market share of lit markets as a percentage of overall market volume has remained relatively constant over time.
>
> . . . .
>
> We have repeatedly heard that institutions representing long term investors through mutual funds feel it is imperative that the choice of interacting in the public markets be left with the investment professional making investment decisions."[28]

Fidelity Investments expressed a similar view in its response to the SEC's rule proposal on "Regulation of Non-Public Trading Interest"[29]:

> "Fidelity uses a wide variety of trading venues and trading strategies to execute client orders as efficiently as possible, and we do not favor one type of trading

[27] Letter dated April 21, 2010 from Michael Gitlin, Head of Global Trading, David Oestreicher, Chief Legal Counsel, and Christopher P. Hayes, Senior Legal Counsel, T. Rowe Price Associates, Inc., http://sec.gov/comments/s7-02-10/s70210.shtml (accessed January 10, 2011), p. 3.
[28] Letter dated April 30, 2010 from Kimberly Unger, Executive Director, The Security Traders Association of New York, Inc.,http://sec.gov/comments/s7-02-10/s70210.shtml (accessed January 10, 2011), p. 10-11.
[29]Securities Exchange Act Release No. 60997 (November 13, 2009), 74 FR 224 (November 23, 2009), http://sec.gov/rules/proposed/2009/34-60997fr.pdf (accessed January 10, 2011).

business model or trading venue over others. On balance, we believe that a framework that supports multiple, competing trading venues is good for the securities industry. Dark pools (and other dark sources of liquidity) enable large market participants to shield their trading objectives by placing orders without having to display their full trading intentions to the entire market. As a result, dark pools can reduce transaction costs by limiting potential information leakage and associated market impact that can occur when trading significant blocks of stock. Fidelity believes that these dark pools are important tools that enable us to execute trades efficiently while protecting our long-term investors from potentially opportunistic trading strategies."[30]

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In a September 24, 2009 speech, Paul Schott Stevens, the President of the Investment Company Institute, discussed the importance of controlling market impact costs. Mr. Stevens defined market impact as "the amount by which the price of a stock moves against the trader during the time it takes to execute the trade."[31] "The bigger the trade," Mr. Stevens said, "the greater the risk of an adverse price movement."[32] According to an article reporting on his remarks, "Mr. Stevens noted that the development of new venues for trading, such as dark pools, have helped funds reduce their trading costs."[33]

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The views of the buy-side have been echoed by many of the leading industry experts on trading and market structure and by academics with expertise on trading and market structure.

According to a report by the TABB Group, a research and consulting firm that conducts extensive research on trading and markets,

> "... institutional investors tend to keep their trades quiet and not telegraph their intentions. Many investors feel that by placing limit orders or showing their hand, they will leak information into the market and invite other traders to take advantage of them."[34]

The TABB Group report wrote similarly in another report:

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[30] Letter dated February 23, 2010 from Scott C. Goebel, Senior Vice President, General Counsel, FMR Co., http://sec.gov/comments/s7-24-09/s72409.shtml (accessed January 10, 2011), p. 2.
[31] "ICI Wants Wider Debate On Markets", *Compliance Reporter*, December 4, 2009, http://www.compliancereporter.com/SubContent.aspx?ArticleID=2352170 (accessed January 11, 2011) ("Compliance Reporter").
[32] Compliance Reporter.
[33] Compliance Reporter.
[34] Adam Sussman, Larry Tabb, and Robert Iati, The TABB Group, LLC, "US Equity High Frequency Trading: Strategies, Sizing and Market Structure", September 2009, p. 22.

> "In fact, there are numerous executions that fall between 2,000-9,000 shares. This subcategory of blocks, sometimes referred to as the 'demi-block,' has grown over the past few years. These prints are significantly larger than the average 300 share print found on most liquidity venues, but smaller than the traditional over 10,000 share blocks. Even some volume from traditional block dark pools falls into this segment. Trades within this category can have just as much market impact as those at the 50,000 share range."[35]

Quantitative Services Group, a provider of advanced trading analytics and investment consulting services, wrote similarly in a recent report:

> "It's well known that sophisticated stat-arb models routinely monitor market data and the depth of limit order books to detect asymmetries in trading interests. The goal is to exploit and profit from them before the flows reverse and larger traders have a chance to finish their orders. These HFT strategies increase the costs of completing institutional trades and often introduce 'adverse selection' as orders are completed in names that are moving contrary to the institutional trader's investment goals."[36]

According to Wayne Wagner, Chairman of Plexus Group, a pioneer in transaction cost analysis for institutional investors, in testimony before the United States Congress in March 2003:

> "For institutional trades to squeeze through the market, they must be ground down to a size that can be accommodated in the market. In the process, the time to complete the order necessarily lengthens.
>
> This creates opportunities for market insiders and middlemen to make money through unnecessary inter-positioning and parasitical front-running. The resulting delay and impact costs reduce investment performance.
>
> The best market for small investor trades may not serve very well those same small investors who invest via mutual funds and other co-mingled investments. Facilities where large buyers can meet large sellers without leakage will benefit all investors."[37]

According to Professor Robert Schwartz, Marvin M. Speiser Professor of Finance and University Distinguished Professor at the Zicklin School of Business, Baruch College, CUNY,

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[35] Matthew Simon, The TABB Group, LLC, "US Equity Trading 2010/2011: Outflows, Outrage, and Balance", December 2010, p. 40.

[36] Quantitative Research Group LLC, "Beware of the VWAP Trap", *Research Note*, November 2009, p. 3.

[37] Wayne H. Wagner, Chairman of Plexus Group, Testimony before the Committee on Financial Services, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, United States House of Representatives, Washington, D.C., March 12, 2003, p. 6.

"As noted, quantity discovery is a major function of a marketplace. While a market center such as the NYSE may play the dominant role with regard to price discovery, an ATS such as Liquidnet or ITG's Posit can play a major role with regard to quantity discovery. These systems do so by enabling large buyers and sellers to meet directly.

An ATS's quantity discovery role can beneficially effect price discovery for the broader marketplace. If restrictions are placed on how large buy orders can meet large sell orders away from a primary market center, price dislocations can occur. That is, elephants that are not able to trade with each other can upset the apple cart (or, some might say, the alpha cart) and cause a sharp accentuation of intra-day price volatility."[38]

According to Benn Steil, Senior Fellow in International Economics at the Council on Foreign Relations,

"The problem is that continuous electronic auction markets, as useful as they are, have flaws that are apparent to any institutional trader. They require institutional-sized orders to be chopped up into small bits, each often as little as 1 percent of actual order size, and executed over days or weeks in order to avoid huge market impact costs. That's why in every major U.S. or European marketplace -- New York, Nasdaq, London, Frankfurt, Paris -- about 30 percent of trading volume is executed in blocks, "upstairs," away from these systems.

More importantly, new electronic systems are expanding to make this block trading more efficient. Liquidnet is the most prominent example. By foreswearing limit-order display, or 'pre-trade transparency,' in favor of a structure in which potential matches are revealed only to the relevant buyer and seller, institutions are encouraged to reveal their true order size to the system."[39]

Dr. James J. Angel, Associate Professor at the McDonough School of Business at Georgetown University, an expert on the structure and regulation of global financial markets, recently explained as follows in a comment letter on the SEC's Concept Release:

"Large traders have always been concerned about reducing the price impact of their trades. One of the ways to do this is to limit exposure of their trading interest only to parties who are very likely to trade with them. This limited disclosure reduces the likelihood that other traders will try to go along and

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[38]Robert A. Schwartz, "The Trade-Through Rule Must Go", *Securities Industry News*, February 14, 2005.
[39]Benn Steil, "The End of History and the Last Trading System, Fukuyama Comes to Market Reg", *Securities Industry News*, March 28, 2005.

trade at the same time and increase the market impact of the order. Whether in the murky depths of the ancient NYSE floor, or in the telephone conversations of upstairs block traders, limited disclosure is a longstanding and useful practice. The so-called 'dark pools' along with other innovations provide automated ways for traders to execute their trades better, faster, and cheaper. The exchanges themselves facilitate this selective disclosure through their hidden order facilities.

In reality, there is no such thing as a truly 'dark pool' in the U.S. Immediately after a trade takes place in the U.S., the lights are turned on and the entire world can find out the price and quantity of the trades within seconds. This last sale information is extremely important in price discovery.

There are two concerns with dark pools. First, if too much of the trading interest occurs in dark pools, will this hurt market quality for the rest of investors? So far, there is no empirical evidence that market quality has declined in recent years as dark pools have proliferated. There is good reason to believe that a very large fraction, even a majority, or trading could originate in dark pools with no adverse impact on market quality. As one learns in statistics, one can get a very reliable estimate of a quantity without measuring the entire population. Most surveys of the U.S. population measure only a tiny percentage of the entire population. Similarly, one only needs a statistically big enough sample size to measure the current market price of a stock. Given that the market already has 100% post-trade transparency of price and volume, the markets can thrive even when a large amount of pre-trade activity takes place in the dark.

The second concern has to do with the fairness of access to dark pools and other modern trading facilities. The Commission clearly has a statutory obligation to foster 'fair and orderly' markets, although the exact definition of 'fair and orderly' is not spelled out in the '34 Act. Are dark pools or other trading systems that exclude various participants fair to those who cannot participate? One thing to consider is that retail investors hire brokerage firms to execute their orders. The brokerage firms have a duty of best execution, and many of them use sophisticated order routing technology to get the best execution for their customers. Many firms can and do routinely check dark pools in the hope of getting a better execution for their customers even for simple small retail market orders. Thus, most of these platforms are available to almost everyone through their agents."[40]

[40] Letter dated April 30, 2010 from James J. Angel, Ph.D., CFA, Associate Professor of Finance, Georgetown University, McDonough School of Business, http://www.sec.gov/comments/s7-02-10/s70210-172.pdf (accessed January 10, 2011), pp. 6-7.

In an academic study on equity trading in the 21st Century,[41] Professor Angel, Lawrence E. Harris (Fred V. Keenan Chair in Finance, Professor of Finance and Business Economics, Marshall School of Business, University of Southern California, and Chief Economist of the SEC from July 2002 through June 2004), and Chester S. Spratt (Pamela R. and Kenneth B. Dunn Professor of Finance, Director, Center for Financial Markets, Tepper School of Business, Carnegie Mellon University, and Chief Economist of the SEC and Director of its Office of Economic Analysis from July 2004 through July 2007), wrote:

> "Brokers and others have developed many alternative trading systems to help large traders arrange trades and enhance liquidity provision, while protecting these traders from front-running and quote-matching problems that arise when information about their orders is widely known. Larger traders are anxious to protect the intellectual property and privacy of their trading plans. In a trading floor context, these trades previously used floor brokers who worked their orders based on their experience. Now many large traders use dark pools instead."[42]

* * * * *

Several prominent legislators in the U.S. have recognized the value and role played by dark pools. In a letter to SEC Chairman Mary Schapiro, Democratic Senator Charles Schumer wrote,

> ". . . I recognize the important role that certain ATSs fulfill by executing large block orders on behalf of institutional investors in a non-display environment, and I would urge the Commission to consider an exception to the one-percent threshold as may be necessary to facilitate such block execution services."[43]

Democratic Senator Jack Reed noted at a US Senate subcommittee hearing on market structure that,

> "Dark pools and other undisplayed forms of liquidity have been considered useful to investors moving large numbers of shares since it allows them to trade large blocks of shares of stock without giving others information to buy or sell ahead of time."[44]

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[41] James J. Angel, Lawrence E. Harris, Chester S. Spatt, "Equity Trading in the 21st Century", February 23, 2010, http://www.knight.com/newsroom/pdfs/EquityTradinginthe21stCentury.pdf (accessed January 10, 2011) ("Angel, Harris and Spatt").

[42] Angel, Harris and Spatt, p. 35.

[43] Letter dated October 20, 2009 from Senator Charles Schumer to Chairman Mary Schapiro, http://schumer.senate.gov/new_website/record.cfm?id=316252 (accessed January 10, 2011), p. 4.

[44] Transcript of the Hearing of the Securities, Insurance and Investment Subcommittee of The Senate Banking, Housing and Urban Affairs Committee on "Dark Pools, Flash Orders, High Frequency Trading and Other Market Structure Issues," October 28, 2009, pp. 1-2 ("Senate Subcommittee Hearing Transcript").

Republican Senator Bob Corker similarly noted at the hearing:

> ". . . it seems to me that the dark pools are an outgrowth of electronic exchanges where people are trying to sell large blocks of shares in a way that used to be done by individuals, so if we're going to be almost all electronic exchanges . . . what is another mechanism for large institutional traders with large blocks of stock? What is a fairer way for them to be able to make those types of trades without moving the market substantially and really harming the very people they're investing for? What is a better mechanism than a dark pool?"[45]

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The National Investor Relations Institute, the largest professional investor relations association in the world representing 2,000 publicly held companies, wrote similarly in response to the SEC's Concept Release:

> "In today's market structure, dark pools provide an important function for investors by allowing large block trading with efficiency and anonymity. NIRI urges the SEC to proceed with a thorough understanding of dark pools' price discovery role. If, for example, the proposed changes result in advantages to short term traders at the expense of long term investors, this does not foster fair, free markets for all participants in keeping with the SEC's mission and investor protection role. We appreciate the SEC's focus on large block orders by considering appropriate exceptions to facilitate execution of these large block orders. We also recommend the SEC continue to provide sufficient market flexibility to enable efficient execution of these types of orders."[46]

Canada

In December 2009, the Canadian Securities Administrators (CSA) and Investment Industry Regulatory Organization of Canada (IIROC) issued a joint consultation paper on "Dark Pools, Dark Orders, and Other Developments in Market Structure in Canada."[47] Buy-side firms and buy-side trade groups responding to the consultation paper consistently and uniformly identified the value of dark pools for executing block orders.

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[45] Senate Subcommittee Hearing Transcript, p. 36.

[46] Letter dated February 16, 2010 from Jeffrey D. Morgan, CAE, President and CEO, National Investor Relations Institute, http://sec.gov/comments/s7-24-09/s72409.shtml (accessed January 10, 2011), p. 2.

[47] "Joint Canadian Securities Administrators / Investment Industry Regulatory Organization of Canada Consultation Paper 23-404 – Dark Pools, Dark Orders, and Other Developments in Market Structure in Canada", December 15, 2009, http://www.osc.gov.on.ca/documents/en/Securities-Category2/csa_20101119_23-405_dark-liquidity.pdf (accessed January 10, 2011).

The Investment Counsel Association of Canada, which represents investment management firms registered to do business in Canada as portfolio managers, wrote as follows in its comment letter on the Joint CSA/IIROC Consultation Paper:

> "Dark Pools serve an important function in the marketplace – ICAC believes that there is, and has always been, a need and a role in the marketplace for hidden (i.e. non-displayed) liquidity. With effective and efficient regulation, Dark Pools support the objective of best execution for investors."[48]

TD Asset Management Inc. wrote similarly:

> "It is important for large asset managers to have at their disposal, a variety of tools, including Dark Pools and Dark Orders, to trade large blocks of securities without information leakage to the marketplace. In this regard, Dark Pools and Dark Orders benefit investors and our markets generally in many important ways by lowering trading costs, providing market participants more choice, and spurring competition among trading venues.
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> . . . .
>
> Qualitatively, the positive attributes to Dark Pools include order anonymity that results in reduced market impact and lower trading costs.
>
> . . . .
>
> We believe that Dark Pools should not be required to provide pre-trade transparency of their orders based on a regulated threshold of trading activity, absent any measured benefit to mandating transparency to Dark Pools.
>
> . . . .
>
> In our view, Dark Pools generally benefit investors and markets by reducing trading costs, providing market participants additional trade execution venues, and encouraging innovation and competition among trading venues."[49]

Highstreet Asset Management wrote in its comment letter:

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[48] Letter dated December 22, 2009 from Katie Walmsley, President, and Mark Pratt, Chair, Industry, Regulation & Tax Committee of the Investment Counsel Association of Canada, Senior Legal Counsel, Mackenzie, http://www.osc.gov.on.ca/documents/en/Securities-Category2-Comments/com_20091222_23-404_walmsleyk.pdf (accessed January 10, 2011), pp. 2-3 ("ICA Letter").

[49] Letter dated December 15, 2009 from Barbara Palk, CFA, President of TD Asset Management, Inc., http://www.osc.gov.on.ca/documents/en/Securities-Category2-Comments/com_20091215_23-404_palk.pdf (accessed January 10, 2011), pp. 2-4 ("TD Letter").

"Dark Pools provide two benefits; a forum to execute larger trades with less pre-trade information leakage; [and] more diversity in liquidity sources in that one is not locked to one broker for the order."[50]

In its comment letter, Greystone Managed Investments focused on the importance of providing flexibility to the institutional trader in determining how to most efficiently execute a block order:

"Our submission therefore, takes the viewpoint of a large institutional investor. In this context, it is critical that we remain flexible in our trading decision to ensure we minimize market impact. Particularly for block trades, we need to minimize information leakage. As an institutional manager, we believe we need more flexibility and not less in deciding how we trade.

Institutional traders seek larger contras than are available in the displayed market. The largest cost of trading is the price impact of moving a large block of stock; therefore, greater flexibility is needed for institutional investors.

. . . .

Institutions need full discretion on how to trade their block orders. Institutions need more flexibility and not less in deciding who can see their block order information. Institutions are in the best position to determine how to execute their holdings. Dark pools should not be required to provide transparency of their orders. This allows for institutional managers to maintain anonymity and minimize information leakage."[51]

RBC Global Asset Management Inc. wrote that use of dark pools is consistent with an investment manager's best execution obligations:

"Investment managers have the fiduciary duty to obtain best execution for their clients. Therefore, the determination of how an order is executed is based on the investment manager's evaluation of which marketplace (transparent or non-transparent) will help the investment manager meet this obligation. Further, investment managers are charged with controlling transaction costs in order to deliver the best performance possible to their clients; this responsibility includes considering the cost of market impact made by an order if sent to a transparent

[50] Letter dated December 24, 2010 from Vidis Vaiciunas, Vice President, Head of Trading and Shaun Arnold, Chief Investment Officer of the High Street Asset Management,http://www.osc.gov.on.ca/documents/en/Securities-Category5-Comments/com_20091224_23-404_vaiciunasv.pdf (accessed January 10, 2011), p. 2.

[51] Letter dated December 22, 2009 from Nadine Krenosky, CA, CFA, Chief Compliance Officer of Greystone Managed Investments, Inc., http://www.osc.gov.on.ca/documents/en/Securities-Category5-Comments/com_20091224_23-404_krenoskyn.pdf (accessed January 10, 2011), pp. 2-3 ("Greystone Letter").

marketplace. As discussed in the Consultation Paper, there are clear benefits in using a dark pool. They do assist investment managers in reducing the market impact of placing a large order made on behalf of multiple clients, thereby accessing better execution.

. . . .

As noted above, we generally use dark pools to trade orders that are particularly difficult to execute and to seek large blocks of liquidity while limiting the leakage of trade order information to the market. As well, dark pools are used for price improvement."[52]

Connor, Clark &Lunn Investment Management Ltd.wrote:

"As a general comment, we believe Dark Pools serve an important function in the marketplace, and, for the most part, we are not in favor of introducing significant restrictions on how these venues operate. Dark pools enable investors to provide and source liquidity without directly disclosing order information in the quotes or to a broker. For this reason, they are a complement- not a replacement- to other execution venues in the Canadian market."[53]

* * * * *

Commenters were specifically asked for their views on how dark pools affect market liquidity. In response to this question, The Investment Counsel Association of Canadawrote:

"In our view, Dark Pools contribute positively to liquidity. If larger institutional investors can enter orders without fear of information leakage, then the hidden liquidity that exists on the desks and blotters of buy-side traders, or in their order management systems, is made available."[54]

TD Asset Management Inc., one of the largest asset managers in Canada, wrote similarly:

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[52] Letter dated December 29, 2009 from Daniel E. Chornous, CFA of RBC Asset Management Inc., http://www.osc.gov.on.ca/documents/en/Securities-Category2-Comments/com_20091229_23-404_chornousd.pdf (accessed January 10, 2011), p. 2 ("RBC Letter").

[53] Letter dated January 5, 2010 from Don Towers, Partner, Head of Equity Trading of Connor, Clark &Lunn Investment Management Ltd., http://www.osc.gov.on.ca/documents/en/Securities-Category2-Comments/com_20100105_23-404_towersd.pdf(accessed January 10, 2011), p. 2 ("Connor Clark Letter").

[54] ICA Letter, pp. 2-3.

"We expect liquidity to be enhanced by Dark Pools. We neither expect a material impairment on price discovery nor any excessive market fragmentation."[55]

Greystone Managed Investments wrote:

". . . the core benefit of dark pools is their ability to provide access to liquidity while minimizing market impact."[56]

RBC Global Asset Management Inc. wrote:

"Dark pools provide institutional investors with the ability to seek the type of liquidity they are looking for without experiencing undue market impact. They offer institutional investors the potential to find adequate contra-side trading interest for large, potentially market-moving orders, without affecting prices. However, do to their lack of transparency, dark pools do not necessarily provide a true indication of available liquidity. In our view, the net effect is that for institutional investors dark pools combined with visible marketplaces provide alternatives for optimal execution of orders of different sizes. The increase in the average size of trading in dark pools may provide an opportunity for trade cost reduction to all users.

. . . .

As noted above, we generally use dark pools to trade orders that are particularly difficult to execute and to seek large blocks of liquidity while limiting the leakage of trade order information to the market. As well, dark pools are used for price improvement."[57]

Connor, Clark & Lunn Investment Management Ltd. wrote:

"If anything, Dark Pools increase the liquidity available in the market by providing a way for investors to source liquidity that previously had only been available by calling a broker. Our desk is now able to find and provide liquidity without having to disclose any pre-trade information to a broker or the market as a whole.

. . . .

[55] TD Letter, pp. 2-4.
[56] Greystone Letter, pp. 2-3.
[57] RBC Letter, p. 2.

If the market share of Dark Pools in Canada were to increase, liquidity available in the market would also increase. Dark Pools can bring liquidity to the market that may not have otherwise come to the market."[58]

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Consistent with these comments, TD Newcrest,a securities dealer in Canada that provides research reports on the equity markets, has noted in a research report that institutional traders in Canada

> ". . . remain concerned over information leakage that results from sophisticated pattern recognition as well as aggressive strategies utilised by high frequency traders that are able to maneuver in the market much more nimbly than traditional traders."[59]

Australia

In 2007, the Australian Securities and Investments Commission (ASIC) issued "Consultation Paper 86 – Competition for market services, trading in listed securities and related data." (Consultation Paper 86).[60] In Consultation Paper 86, ASIC requested comments from market participants on a series of market structure issues.

In response to Consultation Paper 86, the members of the institutional trading community in Australia wrotea joint letter discussing the problem of market impact costs and the role of block trading systems in addressing this problem:

> "Pre-trade transparency is not desirable at all when executing large block orders. With regard to best execution, information leakage is an issue that is very costly to institutional investors and any 'minimum condition' that tries to force market participants to review their hand pre-trade goes clearly against best execution . . ."[61]

The institutional trading community in Australia noted further:

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[58] Connor Clark Letter, p. 2.

[59] The Equity Division of TD Securities, "High Frequency Trading Strikes a Chord with Politicians, Regulators and Market Participants", *S&P/TSX Bulletin*, p. 8.

[60] ASIC Consultation Paper 86 – Competition for market services, trading in listed securities and related data, http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/CP_86-Competition_for_market_services%20CP.pdf/$file/CP_86-Competition_for_market_services%20CP.pdf (accessed January 10, 2011).

[61] Letter dated August 17, 2007 from representatives of Australia's institutional trading community to ASIC re: Consultation Paper 86 – Competition for market services, trading in listed securities and related data, http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/Consultation_paper_86_submission_institutionalinvestors.pdf/$file/Consultation_paper_86_submission_institutionalinvestors.pdf (accessed January 10, 2011), p. 3 ("Institutional Investors Letter").

> "The implicit costs of trading (sometimes referred to as "market impact costs") are the costs of exposing a large order to a market that does not have sufficient liquidity to execute that order. Competition will give rise to alternative execution venues. Some of those venues will operate in a manner that protects the confidentiality of customer orders, resulting in significant transaction cost savings for Australia's institutional investors and the millions of beneficiaries of the accounts that we manage.
>
> Today, we rarely expose our full block orders to the public market and in many cases we do not show our full orders to our executing brokers. This is because of the potential market impact costs associated with information leakage from doing so. Alternative trading venues will provide new methods for our orders to interact, resulting in increased market liquidity. . .We do not believe that there is any need for pre-trade transparency for block trades as this would negate the primary benefit of a block trading system."[62]

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ASIC has recognized the views of Australia's institutional trading community on this issue. In a recently issued consultation paper on Australian equity market structure, ASIC wrote:

> "There are some circumstances where pre-trade transparency can adversely impact a market and the investor in terms of price volatility and higher execution costs. For example, a large order can result in significant price movements, where other traders can act on the information before it is filled. In this context, having no pre-trade transparency ('dark liquidity') reduces the possibility of leakage and therefore lowers the costs of trading for these investors."[63]

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IOSCO

In October 2010 the Technical Committee of the International Organization of Securities Commissions (IOSCO) published a Consultation Report on "Issues Raised by Dark Liquidity".[64]In various sections of the Consultation Paper, IOSCO recognizes the value of dark pools for institutions seeking to execute block orders with reduced market impact.

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[62]Institutional Investors Letter, p. 3.

[63]"ASIC Consultation Paper 145 – Australian equity market structure: Proposals," November 2010, http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/cp-145.pdf/$file/cp-145.pdf (accessed January 10, 2010), p. 97.

[64] Technical Committee of the International Organization of Securities Commissions, Issues Raised by Dark Liquidity, Consultation Report, CR05/10, October 2010 ("IOSCO Report").

IOSCO first explains that dark pools have arisen to facilitate execution of institutional orders with reduced market impact:

> "One such innovation is the expanded use of dark liquidity and the development of so-called *dark-pools*. Traders have always sought ways to preserve anonymity and execute orders with minimal market impact. Dark liquidity has long existed, for example, in the form of orders being held *upstairs [at] trading* desks and liquidity offered by firms that internalize their order flow. In recent years, the handling of dark liquidity has been made more efficient due to the use of new technology and trading models. This has resulted in, among other trends, significant growth in the number of dark pools that do not display any quotations."[65]

IOSCO specifically enumerates some of the reasons why traders may use dark pools, including:

> "• to avoid information leakage;
> - to minimize market impact costs;
> - to facilitate the execution of large blocks which may be difficult to achieve on transparent markets due to a lack of depth in the orderbook;
> - to ensure better control of an order;
> - to protect proprietary trading information;
> - to avoid algorithms or programs that seek to identify or *sniff* out dark orders used in transparent markets;
> - to take advantage of the possibility of price improvement; and
> - to minimize transaction costs."[66]

IOSCO further points out:

> "[R]egulators must also keep in mind the trading interests of professional (i.e. non-retail) investors, who are primarily concerned about the costs of pre-trade transparency as they typically trade in very large sizes. It is these trading interests of professional investors that are often cited as one of the major reasons for the current interest in dark pools and dark orders."[67]

[65]IOSCO Report, p. 4.
[66]IOSCO Report, p. 10.
[67]IOSCO Report, p. 15.