



January 11, 2011

VIA EMAIL

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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
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Saskatchewan Financial Services Commission
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Dear CSA and IIROC:

Re: Position Paper 23-405 Dark Liquidity in the Canadian Market (Position Paper)

TMX Group is pleased to respond to the Position Paper and we acknowledge the significant work done by IIROC and CSA staff to put forth a position on dark liquidity that seeks to support the price discovery process. TMX Group believes that it is the price discovery mechanism of a strong, visible marketplace that keeps our capital markets highly efficient. We continue to be concerned that any changes in market structure that have the effect of fragmenting order flow

and drawing liquidity away from these central, transparent marketplaces could damage the price discovery process and in turn the vital capital formation process.

The CSA and IIROC must ensure that any structural changes to our market will facilitate capital formation for public issuers in a fair and transparent manner while maintaining investor protection. On a global scale, Canada is a small and unique market where a few participants control a significant amount of the equity trading flow. Any structural changes contemplated by the CSA/IIROC should be undertaken with the recognition that the behaviour of these few participants in particular can have a significant and broad impact on our market generally. It is for this reason that internalization systems and dealer network facilities should be subject to the same level of oversight, disclosure, and transparency standards as those required from registered marketplaces. Regulation and policies related to all forms of dark trading, whether offered by an exchange, a regulated ATS, or through other order matching systems such as dealer internalization practices or inter-dealer liquidity venues, must be consistent and applied in a manner that does not have the effect of undermining the value of the price discovery process.

The Position Paper sets out CSA and IIROC staff's position with respect to four questions. In our response below, we address each question and staff's view. Defined terms used in our response are taken from the definitions provided in the glossary to the Position Paper. We also discuss other themes raised either at the March 23, 2010 Forum or in written submissions to the CSA/IIROC Consultation Paper 23-404 *Dark Pools, Dark Orders, and Other Developments in Market Structure in Canada*.

Question 1. 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?

CSA/IIROC Staff View: The only exemption to pre-trade transparency should be for orders that meet a minimum size threshold.

Minimum Size Threshold

We believe that staff's position and the proposed exemption, which restricts passive Dark Orders to those of larger size, is appropriate. Our affirmation is conditional upon the selection of a size threshold that is set at a meaningful level. This policy initiative will help to address a number of issues and concerns which we outline below.

Dark liquidity can be varied in its nature, with certain forms of dark order flow being more predatory in nature with the effect of detracting from the central limit order book of a visible marketplace. We agree that the design of the dark liquidity itself is an important factor when determining its impact on price discovery and liquidity at a marketplace. Staff's position to impose a minimum size threshold on passive Dark Orders acknowledges that the facilitation of size execution can be a valuable function of our markets.

TMX Group continues to believe that any regulation of dark liquidity must consider and encompass dealer internalization activities. There is already a significant dark presence in Canada in the form of dealer internalization and the upstairs market, and these forms of dark trading could become more prevalent and meaningful in Canada over time. It is critical that Canada's market structure protects the value and quality of the visible book by having regulation

that does not incent dark trading, including internalization activities, over trading on visible marketplaces.

The proliferation of dark venues in the U.S., where there are now more than 40 dark trading facilities in operation, has resulted in the further fragmentation of liquidity, imposing increasing costs on the industry. Although Canada currently has few dark venues in comparison to the U.S., it is imperative to recognize the potential for a significant amount of liquidity in Canada to 'go dark' as more facilities enter the Canadian market. Canadian regulators must be vigilant in ensuring that our capital markets do not move toward the current U.S. model which is a highly fragmented model that has resulted in the erosion of the visible U.S. marketplaces.

The promotion of a strong and liquid visible market through regulatory policy will assist in pre-empting a similar fragmentation trend in Canada. Regulatory action should be taken now to limit any further costly fragmentation of liquidity, and to mitigate risks that could harm the efficiency and integrity of our market. This policy should be crafted in a manner that does not result in unbalanced regulation that may have the effect of creating incentives for the posting of dark orders over visible orders. Sound policy making and appropriate regulation in this regard will help to ensure that the price discovery mechanisms of visible marketplaces are not eroded, and will assist in preserving capital investment opportunities in Canada.

Size Threshold Measurement

TMX Group recognizes that identifying an appropriate minimum size threshold is challenging. A static threshold for all securities is not ideal. The liquidity level and price of the security should be considered when determining such a threshold. A meaningful size threshold measure is particularly important under the model proposed in the Position Paper given that important exceptions are granted to Dark Orders that meet the minimum size threshold. Depending on the liquidity and price of a security, it is not clear that a trade of 5000 shares should be permitted to execute without providing meaningful price improvement over the NBBO.

If a static minimum size threshold is to be applied, we submit that the threshold should not be less than the greater of: (i) 50 standard trading units; or (ii) \$100,000. Adding this \$100,000 measure to the threshold test is one way in which to take into account the price of the security, and not simply the number of units traded, when determining qualification for the Dark Order exceptions.

Given that the principles behind the UMIR order exposure rule are consistent with the policy objectives of the CSA and IIROC in the Position Paper, it is sensible that this \$100,000 measure would be a minimum starting point¹. Adding an element of value to the size threshold test in the amount of \$100,000, which is the value commonly attributed to "block trades", will ensure that only large, significant trades are being permitted to execute under the exceptions that are to be provided to certain Dark Order trades. If further deliberations ensue regarding threshold side, TMX Group would welcome the opportunity to work with the industry and regulators in determining an appropriate threshold level.

¹ UMIR 6.3 Exposure of Client Orders. The requirement to immediately display a client order to purchase or sell 50 standard trading units or less does not apply if the order has a value of more than \$100,000. These values similarly appear in UMIR 8.3 Client-Principal Trading, where the requirement for price improvement applies only to a client order for 50 standard trading units or less with a value of \$100,000 or less.

Other Exceptions

As a technical point, we note that the definition of Dark Order would appear to include orders that are entered into the TSX Market On Close facility. We do not believe that there should be a restriction on the size of the orders permitted to participate in this type of facility as this is an industry benchmark facility designed for a specific and broadly supported purpose. In addition, market makers on an exchange who are performing their responsibilities in their assigned securities through auto-participation facilities should not be considered to be entering Dark Orders as they are providing a market quality function. We suggest a revision to future dark liquidity proposals or rules to ensure that orders that are "Market-On-Close Orders" (as such term is defined in UMIR), and orders that represent market maker activities through auto-participation facilities are not caught by any new requirements imposed on dark trading.

Question 2. Should Dark Orders be required to provide meaningful price improvement over the NBBO, and under what circumstances?

CSA/IIROC 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.

So long as a size threshold is in place that is appropriate for the security traded, we agree that two Dark Orders meeting the minimum size exemption should be permitted to execute at the NBBO. Meaningful price improvement should be required in all other circumstances. This practice seems to be consistent with the principles behind the UMIR order exposure rule which requires price improvement by the dealer if certain order flow is not immediately exposed to the market. It is also consistent with the current framework that allows the printing of intentional crosses, which are traditionally block trades matched in the upstairs market, at the NBBO.

Our view is contingent on the existence of a minimum size threshold that is appropriate and meaningful, and the requirement for one tick meaningful price improvement as proposed in the Position Paper. If the CSA and IIROC change their position that currently limits exceptions to sizable Dark Orders, or if a change is made to allow sub-penny dark executions (with the exception where the NBBO spread is already at the minimum tick as proposed), then price improvement should be required on all Dark Orders.

Question 3. Should visible (lit) orders have priority over Dark Orders at the same price on the same marketplace?

CSA/IIROC 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.

Visible marketplaces that offer displayed and non-displayed order types have the ability to knit together order flow that might otherwise remain fragmented across marketplaces. We agree with staff's view that Dark Orders should be designed in a way that guarantees priority to visible orders and therefore supports price discovery. We agree that marketplaces should be required to ensure that visible orders are executed prior to Dark Orders at the same price on their own marketplace.

We do not support an exception that would permit two Dark Orders meeting the minimum size threshold to execute prior to a previously booked order at the same price on the same marketplace. We do not believe that Dark Orders of any size should be exempt from the general principle that priority of execution is given to visible orders.

To achieve the objective of price discovery through vibrant visible marketplaces, visible orders should be rewarded. Preserving the priority of orders that have been exposed to the market is therefore an imperative. Dark Orders, regardless of size, should be required to respect and trade against any same-priced visible orders prior to executing against other Dark Orders. The privilege for Dark Orders to trade at the quote without pre-trade transparency should be sufficient in meeting the CSA objective of recognizing the value of accommodating the matching of two large orders. To further allow certain Dark Orders to 'jump the queue' and trade ahead of an order that has been exposed to the market is not appropriate. We believe that there are sufficient incentives for adding liquidity into the market by way of large orders through dark facilities that allow at the touch trading and that have the opportunity to offer their own size placement incentives.

The intent and rationale for this exemption as stated in the Position Paper is to "facilitate greater liquidity interacting with more contra-side participants" to "provide investors with a greater ability to get their orders executed". We fail to see how enforcing visible order priority at the NBBO deters from these objectives. A Dark Order on a marketplace that offers visible quotes still has the opportunity to execute against a contra-side Dark Order, but only after providing priority to any visible orders at the same price. Requiring visible orders on a marketplace to get filled first does not materially diminish an investor's ability to get a Dark Order executed. Providing priority to visible orders at the same price allows for both the continued respect of execution priority of visible orders while facilitating execution opportunities for large orders.

Further, if the CSA and IIROC allow this exemption, the result is essentially allocation at the quote based on size priority, through regulation. If there is a need to encourage trading of large orders, and reward posting of size and maximize size execution opportunities, this can be done directly by the marketplaces through allocation and/or fee models that incentivize these executions. Allocation methodology should not be determined through regulation. The fact remains that if an investor needs to maximize its ability to receive a fill on a large order in its entirety and to ensure priority, then the investor has the opportunity to do so by providing price improvement to the NBBO.

Question 4. What is a "meaningful" level of price improvement?

CSA/IIROC 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 support staff's view. TMX Group has advocated for some time that the CSA and IIROC should ensure a fair and even application of regulation across visible and dark venues regarding trade execution prices. We support staff's view that meaningful price improvement means one trading increment, except where the NBBO is at the minimum tick in which case meaningful price improvement would be at the mid-point of the spread. Currently, Dark Pools have an unfair advantage in that they can print fractional price executions, while fractional prices cannot be

posted on visible marketplaces. As it is inappropriate to allow trades to execute at differing execution increments between a visible and a dark marketplace, we support a change that will move towards a standardization of trading execution prices.

Other Matters for Consideration

Internalization

TMX Group continues to be concerned with internalization at the dealer level, which is essentially a form of dark trading that can cause significant harm to the quality of our capital markets if not adequately overseen by the regulators. This potential harm is particularly relevant in Canada where retail order flow is concentrated among a few dealers. Advanced internalization models at or among these dealers could lead to the negative result of weakened price transparency, liquidity, and price discovery on the visible marketplaces. Internalization benefits a specific segment of intermediaries but it does not benefit the investing community as a whole.

When a participant matches two orders away from the marketplace, this act of internalization prevents one or both of those orders from potentially contributing to central price discovery. At its extreme, if every dealer was allowed to hold back all of its client orders from the visible marketplace and wait for internalization opportunities, the central price discovery mechanism would fail completely.

We continue to ask the CSA and IIROC to be vigilant in reviewing current rules and practices around dealer internalization to ensure that increased internalization at the dealer level does not negatively impact price discovery on visible marketplaces in Canada. A lack of adequate policy and oversight in this area will increase internalization activities, impair liquidity, increase spreads, and increase volatility in the visible market. Any negative impact on the quality and efficiency of our market will impair Canada's competitiveness on the global stage.

Dealer Networks

Related to the topic of internalization generally, we continue to believe that the CSA and IIROC should review the practices of advanced dealer networks offered by third party providers. These dealer networks provide interfacing opportunities and may disclose information similar to indications of interest used by Dark Pools, but they do not execute the match and therefore are not considered to be marketplaces. The practice of using systematic internalization methodology at, and among, dealers is arguably a greater concern than the existence of Dark Pools and Dark Orders since the latter are subject to marketplace regulations. For example, unregulated matching networks can support and enable selective participation which is contrary to the principles of fair and equal access that are a basic tenet of regulated marketplaces. IIROC and the CSA should ensure that the impact of these dealer networks on the Canadian market is understood.

Transparent Trading Policies

We continue to believe that there should be a requirement for both Dark Pools and ATSS that provide pre-trade transparency to disclose their trading policies and to publish trading policy changes for public comment. This would allow market participants to monitor marketplace developments on a continuous basis and to participate in a public dialogue before an ATS implements trading rules that have an impact on market structure. The fact that orders are not displayed on a Dark Pool should not relieve an ATS from the requirement to inform the public of its trading policies, including allocation methodology.

The trading policy transparency requirement can be inserted into NI 21-101, similar to the current requirement imposed on all marketplaces to disclose trading fees². This requirement would not force exchanges and ATSS to publish proprietary or confidential trading specifications. Rather, it would simply require all marketplaces to publish their trading policies that describe the interaction of orders on the marketplace.

Conclusion

We agree with staff that the topics raised in the Position Paper should be addressed immediately. Providing clarity on dark trading rules will benefit the market and should result in the removal of inconsistent outcomes that occur today between trading on lit versus dark venues. We trust that IIROC and the CSA will move forward quickly with regulation that addresses these issues in order to preserve the value of the visible book on Canadian markets.

Yours truly,



Kevan Cowan
President, TSX Markets and Group Head of Equities

² National Instrument 21-101, section 10.1. Disclosure of Trading Fees by Marketplaces – A marketplace shall make its schedule of trading fees publicly available.