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

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**Re: JOINT CANADIAN SECURITIES ADMINISTRATORS/INVESTMENT INDUSTRY REGULATORY
ORGANIZATION OF CANADA POSITION PAPER 23-405 DARK LIQUIDITY IN THE CANADIAN MARKET**

We would like to commend the Regulators for the process to date in examining the issues surrounding dark liquidity and following a process to allow the Canadian capital markets to stay current and competitive in the global arena.

Before answering the specific questions put forward in the Position Paper, we would like to share and develop a number of general comments and concerns which take precedence over the specific answers.

General Comments

Alpha believes that Dark Pools and Dark Orders serve investors interests but also that the *rationale for using dark liquidity* evolved considerably beyond just minimizing market impact when trading large size

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orders. “Dark Pools were created to address the needs of a significant subset of customers; without them markets would suffer of unfilled latent demand and reduced liquidity”¹.

Since the early use of Dark Pools and Dark Orders, there have been *significant developments in the market structure* of equity and other securities markets. We believe that it is crucial that the benefits as well as disadvantages of any dark liquidity market structure feature are evaluated within the context of all those developments.

We also believe that until now *no evidence of harm* has been presented with respect to the influence of dark liquidity on market quality and that further independent, empirical research is required before putting in place a new regulatory framework. In the meantime, commercial innovation through new marketplace functionality should be allowed to develop without regulatory intervention unless there is evidence of harm and under following conditions:

- Marketplaces that provide Dark Pools or Dark Orders should be transparent about their operations to the public and provide detailed information regarding how their Dark Pool or Dark Orders work including disclosure regarding any potential risks; and
- Dealers and other institutions that directly route to Dark Pools and/or leverage Dark Orders should be transparent regarding their decisions to do so.

While strongly supporting the benefits of reviewing the developments with regards to dark liquidity in other jurisdictions, we believe that any resulting suggestions and/or recommendations need to be assessed in light of following considerations:

- The degree of development of and participants’ diversification in the capital markets considered;
- The experience with a multiple marketplaces environment; and
- The fact that Dark Pools play a more important role in very sophisticated capital markets that are characterized by diversified participation.

As a side note we would also like to confirm our understanding that the definition of a Dark Order excludes any marketable or Fill or Kill type of orders. These orders do not have pre-trade transparency and are not reported to an information processor, but we do not believe that it is intended for them to fall under the definition of the Dark Order.

Rationale for using Dark Liquidity

The Position Paper acknowledges that the rationale for using dark liquidity has evolved beyond just minimizing market impact when trading large size orders: “Dark Pools or Dark Orders are also used to protect proprietary trading information, avoid algorithms that are used to identify order parameters and trading strategies, take advantage of possible price improvement, and potentially incur lower trading fees. In some jurisdictions, Dark Pools have also evolved to enable dealers to internalize order flow.”

A similar acknowledgment of the purpose of Dark Pools has been provided by the International Organization of Securities Commissions (IOSCO) in a consultation paper titled “Issues Raised by Dark Liquidity”.

¹ Financial News: In praise of dark pools of liquidity; Xavier Rolet; January 10, 2011.

We fully agree with these views but note that the essence of the proposals in the Position Paper is still centered on rewarding size, and falls short of providing a regulatory environment where dark liquidity can be leveraged for other purposes.

One of those other purposes for leveraging dark liquidity that we would like to particularly highlight is the answer it provides to the implications of the maker-taker fee model, a problem considerably affecting the retail brokerage community in Canada after this fee model was introduced and exacerbated in our market a few years ago.

The negative impacts of the maker-taker fee model on retail brokers are best described in a recent paper by James Angel, Lawrence Harris and Chester S. Spatt titled "Equity Trading in the 21st Century"². Their analysis concluded that the true economic spread at which a security can be traded is artificially tightened by liquidity providers (makers) factoring the rebate amount into the quoted price. Hence the quoted price that the potential taker sees does not represent the true price of that security, as it does not include the active fee he has to pay on top. The net effect is that it is in fact the taker who is funding the spread reduction. Applying this analysis to the retail brokerage business, where it is common practice for the broker to absorb all fees, leads to the following implications:

- With tighter spreads, the retail flow is now predominantly active;
- The retail broker is funding the spread reduction most of the time; and
- Retail brokers experience a multi-fold increase in their cost of trading, as demonstrated by empirical analysis in the Canadian market.

In the US, retail brokers face similar problems, but Dark Pools and internalization systems emerged allowing for active retail orders to be traded at significantly lower cost or even to be "sold" to other parties. This was an innovative market response to a devastating market structure development for retail brokers. It allowed their flow to be again recognized and rewarded for its value; and it allowed them to further lower the fees and improve the quality of service towards the end investor. Without the development of "dark" solutions, we strongly believe that the retail brokerage business in the US would have been abandoned by many of the providers leading to the following implications:

- The concentration of retail brokerage services among a limited number of providers able to absorb the increased costs by leveraging a diversified business model;
- Less competition amongst providers of retail brokerage services and hence less choice for the retail investor; and ultimately
- A decrease in quality of service or an increase in cost for the retail investor.

If the regulators establish a regulatory framework for dark liquidity in Canada that does not allow for options for retail brokers to respond to market developments, , we believe the above mentioned issues will occur in Canada.. Another potential outcome is the migration of a large subset of the Canadian retail flow to other jurisdictions which would also severely impact the quality of Canadian capital markets.

Some argue that the implications of the maker-taker fee model should be addressed at the root by eliminating the model as such, and not by leveraging dark liquidity solutions. Experience shows us however that initiatives of this nature, when taken by a single marketplace (as illustrated by the LSE attempt in September 2009), are not successful. The implications of the maker-taker fee model can only be alleviated through a regulatory intervention that either completely eliminates the model across all marketplaces, or caps the maker rebates and mandates that active fees are passed on to the end client.

² Equity Trading in the 21st Century; James J. Angel, Lawrence E. Harris, Chester S. Spatt; February 23, 2010; <http://ssrn.com/abstract=1630499>

Market Structure Developments

We understand that the issues raised in the Position Paper are a subset of current market structure issues; and that regulatory views on some other issues will be shared with the industry in early 2011.

We want however to emphasize that many market structure issues are strongly correlated and that before a final position is reached on dark liquidity, the issues relating to Dark Pools, Dark Orders, internalization, broker preferencing and the maker-taker fee model should be reviewed in an integrated way.

We also strongly recommend that all dark liquidity market structure features currently available to market participants, be reviewed in the same integrated process in order to avoid regulatory arbitrage. This includes:

- Rules governing the reporting of trades in the upstairs market, today by far the largest Dark Pool operating in Canada;
- The implications of a multiple marketplace environment, where the notion of time priority in general, and the priority of lit over dark, in particular, have already disappeared by the mere existence of multiple venues operating in parallel; and
- Facilities like the Market on Close facility, a market structure feature supporting Dark Orders would be considerably affected by the implementation of the Position Paper.

No Evidence of Harm

The view taken by the CSA, shared by the IOSCO, is that dark liquidity can negatively impact price discovery and liquidity in lit markets. Therefore the use of dark liquidity should be limited to activities where the anticipated market benefits exceed possible negative effects.

While fully supporting the efforts to identify and control negative effects of dark liquidity, we wish to point out that, to date, any analysis with regards to this matter has been exclusively theoretical. No evidence has been presented as of yet that dark liquidity indeed negatively impacts overall market quality.

Through the consultation process across various jurisdictions, many industry opinions and views have been voiced and argued. However, it is important to recognize that a significant number of these views were driven by commercial interests rather than market quality considerations. The most notable example is the strong lobbying against multiple forms of dark liquidity by the majority of the world's largest traditional exchanges, excluding since recently the LSE, which typically do not engage in dark trading and consider it as a major threat to their traditional trading revenue streams.

While there is very little empirical research in the area of interaction between dark and lit liquidity and while the specificities of the regulatory environment in which such research is performed may not make it universally applicable, we want however to point to the recent study done by the Fisher College of Business, "Diving Into Dark Pools".³ The study found "no evidence supporting the hypothesis that dark pool activity has a detrimental effect on market quality". The same study did however find a strong correlation between highly developed dark trading and lit markets characterized by high liquidity and

³ "Diving into Dark Pools," by Saritna But, Barbar Rindi, and Ingrid Werner (DICE Center WIP 2010-10, Fisher College of Business)

low intra-day volatility. “While it is premature to conclude that this is a causal relationship (between dark trading and market quality), we have no evidence to suggest the contrary.”

The new Canadian regulatory framework for dark liquidity should allow for strong, agile and competitive Canadian capital markets. To ensure that this new framework is not overly restrictive at the cost of innovation, investor choice and potentially market quality, we believe that further independent, empirical research is required. Alpha would be happy to financially support such initiative.

Alpha Answers and Reactions to Specific Questions and Staff Related Positions

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?

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

Alpha’s View: While we understand Staff’s intent to protect the price discovery mechanism on the lit markets, we see the following issues with mandating a minimum size threshold for Darks Orders:

- Minimum size thresholds lead to information leakage in a continuous trading model with real time trade reporting;
- Minimum size thresholds limit the use of Dark Pools and Dark Orders to a narrow subset of large order market participants and further limit the latter to a narrow subset of strategies, whereby they have to be willing to take a significant risk by entering their large orders in a single Dark Pool; in today’s markets optimal trading strategies for large orders are characterized by slicing the order into many smaller ones and placing them across various lit and dark market structure features. It is worth noting that the average trade size on the majority of today’s Dark Pools is very close to the average trade size on the lit markets⁴ and that in Canada we have had very limited success with large order only Dark Pools⁵; and
- Establishing a minimum size threshold that applies effectively across all securities under all market conditions and all market models does not seem practically feasible.

In order to determine what orders may be subject to pre-trade transparency exemption, we believe that first of all one needs to take into account the nature of the Dark Order i.e. whether it is a reference priced order – an order whereby its price is derived from a public reference price such as NBBO or VWAP, or not.

Reference priced orders carry a limited pre-trade price signal and therefore should without any hesitation be exempted from pre-trade transparency regardless of their size. There is general

⁴ Average trade size for MatchNow is 400 shares based on IROC data for Q1-Q3 2010. In its ‘Let there be light’ monthly liquidity report on European dark trading venues, boutique US agency broker Rosenblatt Securities noted that the average execution size in the largest European dark pools for October 2010 ranged from 1,831 shares / €16,576 (Nomura) at the top end, falling to 1,024 / €9,270 (Chi-X Europe’s Chi-Delta) down to 593 shares / €5,010 (Citi Match) with the majority of venues trading closer to the latter than the former.

⁵ POSIT, BlockBook and LynXX are some of the block trading pools that do not operate anymore. Liquidnet Canada today has an average trade size of 75,000 shares based on IROC data for Q1-Q3, but represents less than 0.1% of the trading volume in Canada compared to an estimated 15%-20% of the volume being matched upstairs.

consensus that this type of order does not negatively affect the price discovery process in the lit markets; a similar position has been suggested by the IOSCO in the “Issues Raised by Dark Liquidity” consultation paper.

For other orders such a consensus is not present. While standing by our general comments and concerns described at the beginning of this response under *No Evidence of Harm*, we also want to provide some alternative ideas. One approach that could be considered is to seek to establish a balance between the potential negative impact and the benefits of Dark Orders whereby the “right” to be exempted from pre-trade transparency is earned by providing an adequate combination between size and price improvement:

- Dark Orders providing no price improvement would be subject to a sufficient minimum size threshold (e.g. UMIR Order Exposure requirement size);
- Dark Orders providing a small price improvement would be subject to a smaller minimum size threshold; and eventually
- Dark Orders providing a significant price improvement would not be subject to a minimum size threshold.

By following this approach, dark liquidity market structure features can be designed whereby the information leakage would be limited and a broad set of trading strategies can benefit from leveraging such features.

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

Staff’s 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.

Alpha’s View: We believe that reference priced Dark Orders regardless of size and Dark Orders of a size larger than or equal to the Order Exposure requirements should be able to execute at the NBBO. The first, because they do not affect the price discovery process in the lit markets, the latter because they provide meaningful benefit by offering substantial liquidity that would otherwise not be available to the market. For non-reference priced Dark Orders with a size smaller than the Order Exposure requirements we refer to our answer to Question 1.

We also and very firmly believe that there should be no regulatory order size or order type limitations for orders interacting with resting Dark Orders. Any restrictions of this nature should be left to the discretion of the marketplaces and constitute an element of commercial differentiation. We have not heard of any empirically demonstrated or even theoretical negative implications that would require considering such regulatory restrictions.

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

Staff’s 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.

Alpha's View: We strongly believe that implementing regulatory constraints that enforce certain behaviors on a specific marketplace without being enforceable across all marketplaces will yield to regulatory arbitrage and reduced market integrity. Enforcing the priority of lit orders ahead of Dark Orders on a marketplace by marketplace basis will shift Dark Orders from lit markets to Dark-only Pools or lit markets with no liquidity, often operated by the same entities⁶. The number of marketplaces and fragmentation will further increase, driven solely by regulatory arbitrage opportunities, and the stated objective of lit having priority over dark will not be achieved.

If priority of lit orders over Dark Orders at the same price level is required, then the only right approach would be to ensure priority of lit orders over Dark Orders *across all marketplaces*, similar to the "trade-at" rule proposed by the SEC. This rule raises major cost and implementation concerns in the US.

We believe however that there are already sufficient protection mechanisms in place in the current UMIR rules focusing on client priority and order exposure, and question the value of enforcing the priority of lit orders for the following reasons:

- Lit orders benefit from price protection and are entitled to liquidity posting rewards by virtue of the maker-taker fee model; and
- Lit orders have a higher likelihood of fill: by offering execution immediacy an exposed lit order is more attractive to an incoming marketable order than a potential Dark Order.

It should also be noted that today an investor who places a lit order on a visible marketplace may be traded ahead by dark liquidity on another marketplace in multiple ways; the reserve of an iceberg order, an upstairs print or a Dark Order already supported by other marketplaces⁷. We do not have to date any evidence of harm resulting from this situation.

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

Staff's 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.

Alpha's View: While a full tick price increment (mid-point when the spread is already at the minimum tick) may be adequate for large order trades where reduced market impact resulting from dark trading may be worth such a price increment, we are of the opinion that mandating a full tick price improvement (mid-point when the spread is already at the minimum tick) for dark trades (other than the dark-to-dark trades for orders larger than the minimum size threshold) will narrow down the applicability of Dark Pools and Dark Orders to large order trading strategies only.

The Position Paper clearly indicates that the intention of the proposed framework is to "maintain the ability to execute large orders while managing market impact costs, and for smaller orders to continue to interact in Dark Pools with liquidity that may not have otherwise been available, subject to requirement for meaningful price improvement". We are of the opinion that Staff's proposed

⁶ This is evidenced today by market participants printing crosses on marketplaces with no visible liquidity at the NBBO, in order to avoid cross interference.

⁷ Chi-X Canada supports a dark order at the NBBO.

definition of meaningful price improvement will not allow smaller orders to have access to liquidity that may otherwise have been available.

In order to fully understand our opinion, let's look at the context in which trading is occurring today in Canadian markets. The volume weighted spread for most liquid names today averages at 1.6 cents. With spreads this narrow, there are no economic incentives left for liquidity providers to post passive liquidity in the dark with a full tick price improvement (mid-point when the spread is already at the minimum tick) and also forgo the high passive rebates offered on the lit markets. The net effect will be that all Dark Orders will avoid trading with smaller active orders by placing orders with "minimum fill size" conditions.

As discussed earlier, a market structure development of today's markets that cannot be ignored within the frame of defining a meaningful price improvement is the level of the maker/taker fees. With spreads averaging at 1.6 cents and the maker/taker fees hovering around 0.3 cents, trading fees became an integral part of the order routing decisions. Hence there is a need to allow granularity at trading price level in dark liquidity market structure features that permits to adequately take into account those maker/taker fees. This is the only way that the full cost of trading can be properly managed. Therefore and based on the current levels of maker/taker fees, we believe that 1/10 of a penny would be the right minimum price improvement.

Another approach⁸ for dealing with the impact of the maker/taker fee model is to include the active fee in the price of the order and to pass the fees to the client. While this would provide full transparency into true economic spreads, it would lead to prices quoted in hundredths of a penny which would, among other negative side-effects, suffocate the market data infrastructure and overload market display windows. We therefore do not advocate reducing the price increment of the visible orders, but believe it is necessary to allow for sub-penny priced trades in the dark.

We also strongly suggest that Regulators support Dark Orders priced at the mid-point of the spread regardless of the spread size, as that allows large orders to hide the side of the imbalance.

⁸ Equity Trading in the 21st Century; James J. Angel, Lawrence E. Harris, Chester S. Spatt; February 23, 2010; <http://ssrn.com/abstract=1584026>

Alpha appreciates the opportunity to provide comments and would be happy to discuss our responses.

Sincerely Yours,



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