

January 17, 2010

*VIA ELECTRONIC-MAIL AND OVERNIGHT 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 Securities Commission  
Superintendent of Securities, Yukon Territory

c/o John Stevenson, Secretary  
Ontario Securities Commission  
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Toronto, Ontario M5H 3S8

-and-

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**Re: Comments In Response to Joint Canadian Securities  
Administrators/Investment Industry Regulatory Organization of Canada  
Position Paper 23-405 – Dark Liquidity in the Canadian Market**

Dear Sirs and Madams:

We at Connor, Clark & Lunn Investment Management Ltd. (“CCLIM”) are pleased to take this opportunity to provide our comments on the issues raised in the above-mentioned Position Paper.

By way of background, CCLIM is an independent investment management company which manages approximately \$22 billion in assets on behalf of pension fund sponsors, corporations, foundations, endowments, mutual funds and qualified individual investors. CCLIM provides equity (Canadian and United States), fixed income, balanced and alternative investment solutions such as market neutral and high income strategies to clients.

CCLIM is a member of the Portfolio Management Association of Canada (“PMAC”) and as such, we support the submission of the PMAC in response to the Position Paper.

CCLIM previously provided comments in response to the Canadian Securities Administrators (“CSA”) Consultation Paper 23-404-Dark Pools, Dark Orders, and Other Developments in Market Structure in Canada (“Consultation Paper”). In this current letter we expand on our previous comments and respond to the immediate questions presented in the Position Paper.

## **I. Executive Summary: A Timely and Well Designed Proposal**

Although dark pools and orders in aggregate represent only a small percentage of daily volume in Canadian equities, they now represent over 16.2% of consolidated volume in the United States (“US”), up from 3% just three years ago.<sup>1</sup> This volume in the US is spread across more than 32 separate dark pools and exchanges.<sup>2</sup> Although we have not seen the same rapid proliferation in Canada—*yet*—dark marketplaces and order types are knocking on the door. In July 2010, Alpha ATS LP (“Alpha”) filed a proposal for Alpha IntraSpread, which would enable orders to interact without pre-trade transparency.<sup>3</sup> If approved, it seems likely other Canadian marketplaces will follow Alpha’s lead. As indicated by the Technical Committee of the International Organization of Securities Commissions (“IOSCO”) in its October 2010 report on dark liquidity, “the same drivers of dark pool growth in the United States...could also drive growth in Canada...”<sup>4</sup> As such, we commend both the CSA and the Investment Industry Regulatory Organization of Canada (“IIROC”) for taking a proactive approach to this important issue even while still in its infancy in Canada.

The model outlined in the Position Paper maintains the flexibility needed to execute large orders and, at the same time, encourages the use of lit markets, when possible. For this reason, we agree with the positions presented and would support proposed rule changes to reflect the stated views.

## **II. Background Information Shaping CCLIMs Perspective on the Position Paper**

Before assessing the specific questions identified in the Position Paper, we will first provide our general perspective on the role of dark pools in the market. Because of the limited presence of dark pools in the Canadian market today, much of our perspective is shaped by our experience

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<sup>1</sup> See “Let There be Light,” Rosenblatt Securities Inc., November 23, 2010.

<sup>2</sup> See SEC Concept Release on Equity Market Structure, Jan. 14, 2010 (File No. 34-61358).

<sup>3</sup> See [http://www.osc.gov.on.ca/en/Marketplaces\\_ats\\_20100716\\_proposed-changes.htm](http://www.osc.gov.on.ca/en/Marketplaces_ats_20100716_proposed-changes.htm) for original filing published on July 16, 2010 and [http://www.osc.gov.on.ca/en/Marketplaces\\_ats\\_20101214\\_rfc-intraspread.htm](http://www.osc.gov.on.ca/en/Marketplaces_ats_20101214_rfc-intraspread.htm) for amended filing published on December 14, 2010.

<sup>4</sup> See IOSCO, *Issued Raised by Dark Liquidity, Consultation Report*, October 2010, page 10.

with US dark pools. Although a separate regulatory jurisdiction and market structure, we think this US experience is relevant since, if dark pools are permitted to proliferate under the current model in Canada, the market structure in Canada would likely begin to look very similar to the US.

We also note that while our position on dark liquidity has not changed substantially since our previous submission, it has changed in certain areas. This is a result of a number of factors, including more direct experience with dark pools, more complete data for analysis, and more in-depth understanding of dark pool operations based on discussions with brokers and dark pool operators.

A. Not all Dark Pools are Created Equal

As we stated in our previous submission, we believe dark pools have served an important function in the market by facilitating the direct interaction between large investors. Dark pools have enabled investors to provide and source liquidity without directly disclosing order information in the quotes or to a broker, behaviors that could have substantial and adverse price consequences. For this reason, they have been a complement (not a replacement) to other execution venues in the Canadian market.

Over the past several years, particularly in the US, dark pools have grown in both market share and scope. The vast majority of dark pool trading now occurs in small order sizes—sizes comparable to executions on the lit markets. Dark pools as a whole have morphed from institutional block trading networks to retail/algorithmic execution and, in the US, broker internalization venues, both of which compete with the lit markets.

To illustrate the fundamental differences between the two types of dark pools, we provide the following table, which ranks US dark pools based on average execution size (the table is truncated beyond the top 6 average trade size dark pools).

<b>Marketplace Trade Size Rank</b>	<b>Average Trade Size (Shares)</b>
1	49,000
2	47,000
3	6,000
4	360
5	322
6	317

*Source: Rosenblatt Securities, Inc.*

Not all dark pools are created equal. There is a pronounced demarcation between types of dark pools. Ranked strictly by execution size, the 4<sup>th</sup> highest trade size dark pool has an average execution size of less than 400 shares, or less than 1% of the average trade size at the largest dark pool. Clearly some cater to the block trading community and others cater to smaller order execution.

As mentioned above, block execution dark pools serve to bring natural buyers and sellers together in a non-intermediated fashion. Users of these dark pools are typically as interested in simply finding a counterparty willing to trade significant size as they are in seeking out “the best quoted price” or “price improvement.”

Users of small execution size dark pools, on the other hand, tend to be more varied, including but not limited to market makers, high frequency traders, retail (directed by brokers), institutional algorithmic (directed by brokers), and other institutional. Unlike the institutional dark pools, investor orders do not always interact on these venues. In fact, some of these systems are entirely intermediated and serve as internalization platforms.<sup>5</sup>

*Dark pools with average trade sizes less than 400 shares represent 15.4% of consolidated trading volume, or 95% of overall dark pool and dark order execution in the US. The vast majority of dark pool trading is now in size increments roughly comparable to that available on lit markets.*

Because of the sheer market concentration of dark pools catering to smaller execution sizes relative to their larger counterparts, the fundamentally different role they serve in the market, and the more directly they compete with the lit markets, the remainder of this section will focus on just this category of dark pool.

#### B. Small Order Size Dark Pools Impose Costs on the Market without Demonstrating Measurable Benefits

##### *SMALL ORDER DARK POOLS REDUCE TRANSPARENCY*

At the highest level, we believe the most efficient market structure is one with complete transparency: transparency about order prices, order sizes, order handling, fees, ownership, latency, etc. “Sunshine is the best disinfectant.”<sup>6</sup> With complete transparency, all participants can compete on equal footing, which ensures executions are appropriately priced.

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<sup>5</sup> See “Dark Pools 2009: Not So Dark Anymore”, Aite Group, September 30, 2009 or <http://www.aitegroup.com/Reports/ReportDetail.aspx?recordItemID=596> for a synopsis of this report.

<sup>6</sup> Louis D. Brandeis (November 13, 1856-October 5, 1941), Associate Justice on the Supreme Court of the United States from 1916-1939.

To the extent systems emerge that do not promote transparency and the downstream benefits of transparency, we should evaluate whether the benefit of the system is worth the potential cost of reduction in transparency.

As expressed above, it is our view that, *in a continuous market*, orders currently sent to the upstairs market (whether a broker's cash desk or an electronic block dark pool) are one such valid exception. Imagine a scenario in which a block order was published in full in the lit market. The price impact associated with such publication could be far beyond what an investor would pay managing the order in the upstairs market. As a result, without the upstairs market, such large orders simply wouldn't exist. The upstairs block market does not reduce the transparency on the lit market because these orders would never be sent to the lit market to begin with.<sup>7</sup> Thus there is no cost associated with a reduction in transparency and there is a clear transaction cost benefit to investors.

The same does not hold for small or child order executions (whether from individuals or institutions) as there are far more participants willing to trade in smaller sizes on a continuous basis. The continuous lit market is a way for all investors to compete on a level playing field for the execution of these orders. Importantly, these orders would exist regardless of whether they were represented on lit or dark markets. When these orders are diverted from the lit market there is a reduction in price transparency and liquidity.

With the technological advances in computer and information networking over the past decade, the trend in other service industries—real estate, personal travel, etc.—is toward *more* transparency and *less* intermediation. We question why the financial services industry would consider taking a step in the opposite direction by diverting executions from transparent markets to dark markets?

#### *WHERE'S THE "PRICE IMPROVEMENT"?*

We find no compelling evidence that dark pools and dark pool internalizers (in the US) provide substantial execution benefits to lit markets. Reviewing our own executions in inter-listed securities from 2010, we compare execution prices on dark pools with execution prices on lit pools. In particular, we measure fill prices relative to the bid-ask midpoint prior to each trade. The greater the difference the greater the "effective spread" we pay for the execution. We find about a half-basis point difference between dark pool executions and light market executions.

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<sup>7</sup> We further note that, by definition, a block is an order that a trader believes cannot be effectively and fully executed in the lit market. Many large block-size orders are traded—either in full size or broken up into child orders—in lit and dark markets alike.

With the average bid-ask spread of approximately 12 basis points, this improvement is incremental at best and certainly not indicative of meaningful price improvement in dark pools.

Unlike its institutional counter-part, this newer breed of dark pool that now dominates dark pool trading detracts from overall market quality and does not serve to reduce transaction costs for investors. In our view, the markets would be better served having smaller investor orders (whether from individuals or institutions) in the “sunshine” of the transparent markets.

The views outlined in the Position Paper directly and completely fix the issues introduced by small order dark pools and should serve to prevent unnecessary diversion of order flow from light to dark markets. We respond below to the specific questions set forth in the Position Paper.

### **III. Response to Specific Questions Set Forth in the Position Paper**

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

We concur with the Position Paper that it makes sense to offer an exemption from the pre-trade transparency rule for orders that exceed a certain size. The important principle here is the threshold should be large enough that orders that would otherwise be transparent will not become dark. We believe an exemption for orders of 50 board lots or more—as mentioned in the Position Paper—is reasonable and puts dark marketplaces on a comparable level with block desks in Canada, which are able to cross orders of 50 board lots or more.<sup>11</sup> This threshold is also equivalent to the one used in the client exposure rule, which states that orders below a certain size must be directed to a market for display.<sup>12</sup> Having consistency across all of these rules makes sense as it is both intuitive for them to have the same threshold and operationally simple.

Some have expressed concern over the signaling aspect of having an effective minimum size threshold for passive orders in dark pools. In particular, if a small active order fills in a dark pool, it signals a passive order on the other side of at least 50 board lots. We do not view this as a concern as most dark pools (including both in Canada) enable users to specify a minimum fill quantity. As a result, traders concerned about signaling can simply use this feature to limit their exposure to these small, active orders.

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

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<sup>11</sup> See UMIR 8.1, Client Principal Trading.

<sup>12</sup> See UMIR 6.3, Exposure of Client Orders.

As discussed above, there is a cost to diverting order flow from a lit market. The more order flow diverted from the lit market, the less incentive participants have to establish prices on the lit markets. Because of this, we agree it makes sense to require some level of price improvement paid by the passive side of a dark pool execution. This, in a sense, is the payment required to divert order flow from the lit market.

This “payment” should not be required if the order interacts with another large order exceeding the pre-trade transparency exemption threshold. In this case, as we discussed above, the other side of the trade would likely also not have been sent to the lit market due to its size. And thus there is no cost incurred by participants on the lit markets as a result of this dark pool execution.

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

Yes, for the reasons set forth in response to the previous question. Further, it would be inconsistent to permit Dark Orders to have priority ahead of visible orders within the same marketplace but prohibit the execution of Dark Orders at the same price on a separate marketplace.

**What is a “meaningful” level of price improvement?**

A meaningful level of price improvement should be equivalent to the minimum tick size as this is the minimum amount a trader would need to improve upon an existing passive order on an exchange to obtain first priority. For consistency, it makes sense for this to extend to dark pools as well.

**IV. Indirect Issues**

Before we close, we would like to bring attention to a separate, although related, issue that we believe deserves attention as the market micro-structure in Canada evolves. And that relates to multi-marketplace trading. We welcome the competitive value of a multi-marketplace environment, although we also believe there is a point of diminishing and possibly negative returns as the number of marketplaces expands. For example, examining our fills in Canadian equities for the month of July 2010, we see fills from 25 different execution venues.<sup>13</sup> Every time an order (either parent or child) is presented to a market, information is leaked, regardless of whether or not that order was filled. The greater the number of markets across which liquidity is dispersed, the lower the likelihood of finding liquidity on the first try. There are ways to increase the probability of finding liquidity on the first attempt, however one must question:

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<sup>13</sup> The majority of these venues are domiciled in the US.

1. Is this necessary complexity or is it excessive complexity?

and

2. Who benefits by this complexity?

As mentioned above, there is a cost to highly fragmented markets. Just as we believe participants should be required to provide meaningful benefits when diverting order flow away from the transparent markets, we also believe new marketplaces should show a meaningful benefit when increasing fragmentation. We do not believe fragmentation in Canada has become excessive to date, however we do believe this issue is worth consideration as the number of marketplaces continues to expand.

## V. Conclusion

The first wave of marketplaces that emerged in response to the important regulatory changes facilitating the entry of new marketplaces in both the US and Canada led to substantive improvements in equity trading on both sides of the border. Trading in the US—which just 14 years ago was dominated by telephone and rudimentary order messaging—has become almost entirely automated, exchange fees in both countries have come down, and systems performance in both countries has significantly improved.

This latest wave of competition—small order dark pools competing with light pools—does not provide such an obvious benefit. In fact, because of the migration away from transparency and toward intermediation and complexity, we believe it comes at a cost.

We credit both the CSA and IROC for taking a proactive position to keep the Canadian markets on a path that ultimately serves the end investor. For the reasons set forth above, we are supportive of the views presented in the Position Paper. Should you have any further questions, please do not hesitate to contact either Jenny Drake ([jdrake@cclgroup.com](mailto:jdrake@cclgroup.com)) or myself ([drtowers@cclgroup.com](mailto:drtowers@cclgroup.com)).

Respectfully submitted,

Connor, Clark, & Lunn Investment Management Ltd.



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