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January 17, 2011

**Re: Joint CSA/IIROC Position Paper 23-405 Dark Liquidity In The Canadian Market**

Dear Sirs:

TD Securities welcomes the opportunity to provide comment on the joint CSA/IIROC position paper "Dark Liquidity in the Canadian Market", published November 19, 2010.

As executing broker for TD Waterhouse, the largest discount retail brokerage firm in Canada, TD Securities has been directly impacted by recent changes in Canadian market structure, through increased investment in technology to support multiple marketplaces and smart order routing, and higher execution costs resulting from the make/take exchange pricing model. These market structure changes have led to significantly higher third-party intermediation, fragmentation and a much more complex trading environment. In addition to acting as executing broker for TD Waterhouse, TD Securities is a significant full-service institutional broker-dealer, and is under increasing pressure to offer institutional clients advanced execution options that frequently include the use of dark liquidity facilities on various Canadian marketplaces.

It is our view that Dark Orders and Dark Pools represent an opportunity to provide clients with advantageous pricing through price improvement relative the National Best Bid and Offer (NBBO), and offset the costs of the make/take model, while adding liquidity to the Canadian market. We encourage innovation in Dark Order types and Dark Pools in



Canada, and believe that an appropriate framework for dark liquidity will benefit the marketplace as a whole.

In the discussion below, we wish to provide some perspectives on the need for dark trading in the Canadian marketplace in today's market structure. We believe that dark pools and hidden liquidity are a necessary response to the unintended consequences of the prevalent make/take pricing structure of today's marketplaces. By addressing the imbalances and externalities created by make/take pricing, one would improve the transparency of the visible markets, align trading incentives more closely to each party's economics (in terms of all-in trading costs), and make Canadian equity markets more fair for all participants. In such an environment, we believe significant restrictions on the functionality of dark pools will be unnecessary, and dark pools will evolve with the needs of Best Execution rather than the objective of managing the costs of trading.

## **Background Information**

We feel it is helpful to compare the U.S. experience with dark liquidity to Canadian market structure, to contrast similarities and differences between market environments, and explain the motivating factors behind the creation of dark liquidity.

Both the Canadian and U.S. market environments share similar marketplace pricing models, known as "make/take", where providers of liquidity (passive orders) are paid a rebate by the marketplaces, and takers of liquidity (active orders) are charged a fee. The difference between the liquidity rebate and take fee, or exchange spread, represents the execution fee paid to the marketplace itself.

The introduction of liquidity rebates has attracted a new class of market participants, high frequency traders (HFTs), who derive revenues by posting passive orders on marketplaces to collect rebates. The TSX has taken an active and leading role in bringing high frequency traders to Canada through the creation of their aggressive make/take model in October 2008 (the "Electronic Liquidity Provider" Program).

It has been argued that the introduction of the make/take model has decreased bid offer spreads and increased liquidity, however we see the model as significantly distorting market dynamics by replacing transparent bid offer spreads with an opaque set of exchange-sponsored cash flows between market participants.

This distortion occurs since the true economic cost of trading is the sum of the visible bid offer spread plus the take fee or liquidity rebate, but the make/take payments are not consistently passed to the ultimate client. In the case of retail customers, brokerages generally do not pass make/take fees to the client. On the other hand, high frequency trading firms generally operate on a pass-through rebate model and are fully exposed to marketplace fees.

As an example, there is no economic difference in the total cost of trading if average spreads are 2 cents with no take fee, or are 1.65 cents with a 35 mil take fee. However in the second case, the visible spreads are artificially compressed, which gives an advantage to the marketplace with the tighter visible spreads, while the total economic cost becomes obfuscated by the hidden take fee.

When a client purchases stock from a high frequency trader in the second example above, the retail broker pays the exchange 35 mils. The exchange collects an exchange spread (say 4 mils) and pays the remaining 31 mils to the high frequency trader. This in effect creates an indirect cash flow from retail brokers to high frequency traders, facilitated by the exchanges.

In addition, the existence of rebates encourages sophisticated high frequency traders to “stack the quote” by bidding and offering in large size. While this is certainly a benefit for small investors with orders that can be filled “on the quote,” it also disincentivizes traders from placing natural bids and offers in the market, as these new bids and offers would be behind a large volume of HFT orders. In turn, this leads to a greater proportion of client orders filled actively by crossing the bid-ask spread. The result is a combination of worse average fill prices for the end clients (through more frequent crossing of the bid-ask spread), and much higher marketplace fees for the broker (through a higher active/passive ratio).

The make/take model also distorts competition between marketplaces. Best price execution rules, the new Order Protection Rule, require orders to be routed to the marketplace with the best quoted price. Marketplaces benefit from increased market share by offering higher rebates, which incentivizes liquidity providers to establish top-of-book prices more frequently at that venue, which in turn drives additional active flow to the marketplace through best price execution rules. Once one marketplace has set a high level for liquidity rebates (as the TSX has done with the ELP program), other marketplaces are forced to follow to remain competitive in attracting liquidity, leading to a ratchet escalation of make/take fees and a divergence between visible spreads and true economic spreads. Retail brokers bear the cost of this competition between exchanges, not the exchanges themselves.

Finally, the existence of rebates (and the lack of consistent pass-through) means the public record of trade prices, the tape, no longer accurately reflects the economics of each trade. If a client sells stock to a rebate-sensitive HFT for \$10.00 per share, the client receives the full \$10.00 per share, but the HFT will only pay the traded price less the rebate. The tape will indicate that both parties traded at \$10.00, with no disclosure of who received a rebate. Today, high frequency trading firms quote on stocks fully factoring in the level of rebate, and thus the false transparency offered by visible bid-ask spreads hides actual trading economics from the investment community.

In the U.S., the SEC has capped take fees at 30 mils to prevent an unlimited escalation of liquidity rebates. No such cap exists in Canada, where take fees are already above the U.S., reaching as high as 35 mils. In addition, the Canadian marketplace has a

significantly higher proportion of low-priced, highly-liquid stocks than the U.S. marketplace, and thus the average rebate as a percentage of trade value is significantly higher in Canada than in the U.S. All else equal, we believe this is an argument for Canadian marketplaces to pay lower rebates than their U.S. counterparts, the opposite of the status quo.

The make/take model has also encouraged abusive behaviour, such as quote locking, where participants enter resting orders which would otherwise be tradeable on other marketplaces in order to redirect liquidity rebates to themselves. Canadian regulators have rightly banned this practice, but we feel the locked-market rules only address the symptom, not the underlying cause.

Another potential abuse created by make/take pricing is fee arbitrage through wash trading. If two related parties, one executing through a retail broker and the other represented as an HFT were to trade with each other, they could collect riskless rebates at the expense of the retail broker. Such abuse has already been reported in the U.S. and may be occurring in Canada, but is difficult to detect.

James J. Angel, former chairman of the NASDAQ Economic Advisory Board, Lawrence E. Harris, former Chief Economist of the SEC, and Chester S. Spatt, former Chief Economist of the SEC have voiced similar concerns on the make/take model in a recent paper:

*"The elimination of access fees would also cause securities markets to conform to common agency law. Common law generally prevents agents from collecting fees from people seeking to do business with their clients. Such fees are prohibited because they inevitably reduce the value of the business that the clients receive. Oddly, these fees have been accepted in securities markets where exchanges act as agents for the traders that post orders on their books and where brokers act as agents for their clients. Exchanges should not be allowed to require that traders pay them to trade with their clients; neither should brokers be allowed to receive liquidity rebates for routing client limit orders to make-or-take exchanges. In other contexts, these payments would be recognized as illegal kickbacks."*<sup>1</sup>

In the U.S., dark pools have evolved as a response the make/take model, to minimize the costs this model imposes on retail orders in particular. By interacting with retail orders at the bid/offer, or with sub-penny price improvement, firms are able to directly capture the value of retail flow and return that value to retail brokers by way of payment-for-orderflow, which in turn benefits retail clients through lower commissions and enhanced services.

A rational observer may note that a more direct solution to the distortions created by make/take would be the elimination of this model, or a requirement that all make/take fees be passed to the ultimate client. The U.S. practice of payment-for-orderflow only

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<sup>1</sup> "Equity Trading in the 21<sup>st</sup> Century"; James J. Angel, Lawrence E. Harris, Chester S. Spatt; February 23, 2010.

adds another layer of obscured cash flows on top of opaque marketplace-sponsored cash transfers. The U.S. model leaves much to be desired in terms of transparency, but under the context of make/take pricing, dark pools form an important mechanism to level the playing field between clients and liquidity providers. In Canada, no such channel exists, which tips the economic balance heavily to the side of high frequency traders, especially considering Canadian take fees and liquidity rebates are higher than those in the U.S.

## **CSA/IIROC Dark Pool Position**

The CSA/IIROC position paper makes the following recommendations on Dark Orders:

- Passive Dark Orders be restricted to a size that meets or exceeds a minimum size threshold.
- Active orders with a size less than the minimum size threshold must receive meaningful price improvement over NBBO when interacting with passive Dark Orders. There would be no price improvement requirement for active orders that meet or exceed the minimum size threshold.
- Visible orders execute before Dark Orders at the same price, on the same marketplace, except where two Dark Orders meeting the minimum size threshold can be executed at that price.
- Meaningful price improvement is defined as one trading increment, except if the quoted bid offer spread is one trading increment, in which case one-half increment is considered meaning price improvement.

By establishing minimum order size thresholds and price improvement levels of one-half to a full trading increment, CSA/IIROC effectively restricts Dark Pools to be institutional block crossing networks and limits their use for retail order flow. We are supportive of the use of dark pools for block trading (and institutional investors now demand these tools), but we respectfully contend that there are benefits to Dark Pools outside of a purely institutional context, and these benefits would give the community viable alternatives to achieving Best Execution.

U.S. regulations allow individual broker dealers to establish private dark pools (ATs) with no restrictions on order size or minimum price improvement. Orders of any size can be internalized at the NBBO without price improvement and without requiring displacement of the visible order book. While we feel this model is harmful to the marketplace, as it leads to a high level of fragmentation and reduces transparency by encouraging payment-for-orderflow, it does provide a unique case study to observe the value of order flow in a marketplace where flow itself can be segmented and traded as a commodity.

The U.S. experience shows retail order flow is more valuable than the blended order flow directed to visible exchanges. Retail orders are generally more active, diversified and bi-directional than algorithmic institutional orders or high frequency trading orders, characteristics which make this flow attractive to institutional clients and liquidity

providers. In the U.S., retail brokers receive payment of generally 10 mils from ATS firms for active retail orders, compared to Canada where active retail orders are structurally forced to pay 35 mils in exchange take fees. This differential means retail orders in the U.S. enjoy pricing which is 45 mils, or almost half a cent, better than that in Canada, given equivalent nominal prices.

The Canadian practice of co-mingling retail orders with algorithmic institutional flow and high frequency orders on visible exchanges results in retail orders paying wider spreads on average than they could achieve in a purely competitive dark market. This is intrinsically unfair to retail clients.

The 45 mil differential between the U.S. and Canadian marketplaces demonstrates there is powerful economic incentive to segment active retail orders, which if not done through regulator-approved exchange mechanisms, will be achieved through other means, such as private dealer internalization systems or by routing active Canadian retail orders to U.S. dark pools.

We would strongly prefer the pricing of retail order flow be facilitated through transparent Canadian marketplace mechanisms operating under an approved regulatory framework, where the economic benefits are passed directly to retail clients, rather than establish private dealer internalization systems or divert Canadian flow to U.S. dark pools. However, the CSA/IIROC position specifically prevents such a mechanism from being created. The CSA/IIROC position excludes small orders from Dark Pool participation and mandates a price improvement increment which is larger than the economic value of retail order flow, which makes it uneconomic for participants to offer liquidity to retail customers with price improvement.

The CSA/IIROC position is premised on two fundamental concerns: the potential for reduction in liquidity on the visible market, and the removal of small orders from the price discovery process.

We do not see the creation of a Dark Pool for retail orders to be detrimental to marketplace liquidity. The ability to interact with active retail order flow will attract additional liquidity and capital to the marketplace which would not otherwise exist if liquidity providers were at risk of trading with high frequency firms or algorithmic institutional orders, as is the case on the visible markets. Overall liquidity in the marketplace will be increased since the additional dark liquidity would not correspond to a one-for-one reduction in visible liquidity.

We also challenge the assertion that Dark Orders will not participate in price discovery. Liquidity providers in a dark pool assume trading risk, and are motivated to hedge in any available market – including visible markets. In aggregate, the net imbalance of active order flow will generally be reflected in the visible marketplace, and only offsetting flows would be absorbed by the liquidity providers. The removal of offsetting orders has little impact on price discovery, which is predominantly driven by the net imbalance of order flow.

Finally, we believe that the nominally “deep” visible quotes in the market today are subject to quickly fading and repricing to adverse levels in the event of a short-term imbalance in order flow. If the market is one cent wide, but the entry of a single order causes the market to shift by more than the bid-ask spread (as we often see today), then we believe that the one-cent bid-ask spread is largely meaningless for all but the smallest orders. In this environment, we believe the ability of a dark pool to trade with price improvement relative to NBBO would result in both deeper liquidity and greater quote stability at the visible NBBO.

## **Recommendations**

The CSA/IROC position paper is extremely helpful in framing the debate surrounding Dark Orders and Dark Pools, but we feel it has overlooked the role of the make/take model as a motivating factor to the creation of dark liquidity pools.

We strongly recommend make/take exchange pricing be eliminated, to align visible spreads with economic spreads, to ensure quoted prices are directly comparable across marketplaces, and to eliminate opaque cash transfers between market participants. Exchange fees should be symmetrical between liquidity providers and liquidity takers, with liquidity providers being compensated through the visible bid offer spread, rather than receiving side payments from exchanges which are ultimately funded by retail brokers. Competition between exchanges for market share should be driven by product innovation and the merits of technology and operations, rather than by artificial spread compression.

Exchanges may argue the elimination of make/take will widen spreads, disincent liquidity providers, and reduce liquidity. However, wider average spreads would be offset by the reduction in rebates, leaving liquidity providers no better or worse off on average, with the advantage that the true economics of trading would be fully represented in visible quoted prices. Additionally, these wider average spreads would likely be less volatile and thus more accurately reflect fundamental supply and demand conditions. In turn, accurate bid-ask spreads would improve transparency and enhance the price and size discovery process.

A weaker alternative to the elimination of make/take pricing would be a regulatory requirement to pass take fees and liquidity rebates through to the ultimate client, combined with a cap on take fees which is lower than the U.S. cap. While this does not address the comparability of prices across exchanges, it does remove the common agency law problem of make/take pricing, and places limits on the exchanges’ ability to use aggressive rebates to compete for market share.

Under the context of make/take, we also recommend CSA/IROC extend the definition of Dark Orders and Dark Pools to include retail sized orders and sub-penny price

improvement, to counteract the market distortions introduced by make/take pricing and to allow the value of active order flow to be returned to investors.

Such a structure would narrow the 45 mil execution cost gap between the U.S. and Canada, reducing the incentive to route Canadian flow to U.S. markets, and create an open marketplace where all institutional clients, retail clients and liquidity providers could competitively interact with active order flow without exposure to the gaming and predatory practices which make/take has introduced to the visible market.

We are supportive of all initiatives that help counteract the negative effects of the make/take model, and encourage CSA/IIROC to properly consider the distortion incurred as a result of this model when contemplating recommendations for Dark Orders and Dark Pools.

Yours very truly,



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