January 17, 2011

Alberta Securities Commission
British Columbia Securities Commission
Manitoba Securities Commission
Autorité des marchés financiers
New Brunswick Securities Commission
Superintendent of Securities, Newfoundland and Labrador
Registrar of Securities, Department of Justice, Northwest Territories
Nova Scotia Securities Commission
Registrar of Securities, Legal Registries Division, Department of Justice, Nunavut
Ontario Securities Commission
Registrar of Securities, Prince Edward Island
Saskatchewan Financial Services Commission
Registrar of Securities, Government of Yukon Territory

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Re: Request for Comments on the Joint Canadian Securities Administrators (CSA)/Investment Industry Regulatory Organization of Canada (IIROC) Position Paper 23-405 – Dark Liquidity in the Canadian Market

Dear Sirs/Mesdames:

Chi-X Canada ATS Limited ("Chi-X Canada" or "we") welcomes the opportunity to provide comments on the joint CSA/IIROC Position Paper 23-405 – Dark Liquidity in the Canadian Market ("Position Paper").

We commend the CSA and IIROC for their review of the many developments that have taken place in Canadian market structure over the past few years. Similar reviews have been initiated and are currently underway in other jurisdictions around the world, and several new proposals for regulatory reform have been announced or implemented by regulators in the United States, Europe and Australia as a result. As one of several marketplaces that are owned and operated by Chi-X Global, a global operator of marketplaces worldwide, Chi-X Canada has witnessed first hand the market structure changes that have taken place in other jurisdictions. Although regulators globally are addressing similar market structure issues, we cannot overemphasize the importance of focusing on the unique characteristics of local markets when contemplating any new reforms.

In Canada, market structure has undergone positive changes since the introduction of electronic dark pools. Trading practice has shifted from manual processes to reliance on the efficiencies engendered by technological solutions. The advent of algorithms has rapidly decreased average trade size while overall market volumes have increased significantly. The confluence of these developments has resulted in a more liquid and more efficient market. In Chi-X Canada's submission in response to CSA Consultation Paper 23-404, we noted that dark and lit pools operate with interdependencies that often result in greater total "available" liquidity, which in turn benefits all investors. With the use of dark pools and the proliferation of algorithms in Canada, we have seen this decline in "upstairs" block trading – from 39% in 2004 to 15% today.[1] Also during this same period, price discovery has been enhanced by decreased spreads and more liquidity at the NBBO.

Changes in market structure often engender new requirements for participants, leading to the adaptation of existing tools to meet these needs. When dark pools were first introduced, they were intended to automate the upstairs market's manual process, bringing institutional investors price discovery opportunities and the ability to trade anonymously. In today's environment, unlike that of the past, security prices will reflect the impact of material news almost instantaneously. As a result, there is now substantially more risk in trading large size at a single price point. Consequently, traditional block traders increasingly utilize algorithms to adjust to changing market conditions and enhance the opportunity to adapt their strategy to achieve better performance. This, in turn, has resulted in a higher frequency of trading, explaining the trend of decreased average trade size and an increased number of trades for both lit and dark venues.

Additionally, the value proposition of dark pools has changed to reflect the different needs of participants. Traditionally, market impact was primarily incurred in one of two ways: by exposing a large order on a visible exchange, or through the information leakage that occurred when an order was inefficiently shopped in the "upstairs" market. Moreover, computerized tools are today available to monitor trading activity of other participants on a pre-and post trade basis, resulting in a new series of orders leaving a "footprint," or trail, that identifies the trading strategy. So in today's market, not only is it important for participants to reduce the traditional aspects of market impact, it is also necessary to protect their trading strategies from being identified.

[1] ITG Canada, "Canadian Market Microstructure Review - First Quarter, 2010," May 2010.

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In our view, dark order types (on lit venues) assist in shielding trading intentions and reducing footprint, particularly when traded on an anonymous or unattributed book. Separately, dark pools represent the fairest and most efficient form of trading dark liquidity by democratizing access to the non-displayed liquidity that otherwise would sit on traders' blotters, thereby increasing total available liquidity in the market. Both forms of dark liquidity represent valuable trading tools for participants, and can ultimately be used to improve trading performance, particularly when considering the price improvement opportunities and lower fees they may provide.

Given that the trading needs and objectives of investors vary, we strongly believe that participants should be provided innovative tools that can be customized to meet their trading strategies and empowered with the choice of how and when to use them. The use of dark pools and dark order types will depend on a participant's execution objectives, including immediacy of execution, price tolerance, and relative size of the order to average daily volume. We note that the three objectives outlined in the ATS rules when they were introduced are investor choice, price discovery and decreased execution cost.[2]

While we understand the objectives of regulatory retooling, we believe that any adjustments that restrict or prohibit participants, or a subset of participants, from leveraging value added trading tools should be approached with caution and made only in response to an observable threat to market integrity. We believe this should be considered in addition to the ever-present possibility of unintended consequences of any regulatory reform. With that in mind, we respectfully question whether placing restrictions on the use of dark pools and dark order types is necessary at this time given the unique trading and execution quality options they provide participants.

The stated rationale for the proposed directional changes, as outlined in the Position Paper, is that "widespread use (of dark orders) has *the potential* to reduce available liquidity in transparent order books (and that) *there could* be a negative impact on the price discovery process and the liquidity available to those participants that are required to, or have elected to, display their orders on visible markets." We recognize there may be a tipping point when the benefits of investor choice are outweighed by their impact on market quality. However, given the current level of dark liquidity in Canada, and the strong framework that governs dark liquidity, it is not clear that may develop in the future.

We note that dark pools have failed to gain meaningful traction in Canada since their introduction in 2005. Representing less than 3% of total market share today[3], this level of trading volume, in our opinion, is not adversely impacting the price discovery mechanism and concerns about potential future impact seem remote. Overall equity trading volumes have increased significantly during this period, suggesting that there has been no negative impact on spreads or depth of displayed liquidity. However, if there is a concern that dark liquidity is having an adverse impact on price discovery or formation, we advocate a measured approach to ensure an optimal outcome. If any significant impact is evidenced or trends indicate an accelerated movement toward market degradation, the ability to enact and implement reforms should be possible. We note that similar guidance was offered by IOSCO in October 2010 in its recommended oversight principles for dark liquidity:

> *"Regulators should periodically monitor the development of dark pools and dark orders in their jurisdictions to seek to ensure that such developments do not adversely affect the efficiency of the price formation process on displayed markets, and take appropriate action as needed."*[4]

[2] Notice of National Instruments, Companion Policies and Ontario Securities Commission Rules under the Securities Act, (2000) 23 OSCB (Supp), page 299, July 28, 2000.
[3] Position Paper 23-405, page 10769.
[4] IIROC, "Report of Market Share by Marketplace" (for the four quarters ending September 30, 2010).

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The Position Paper also refers to international regulators who have either proposed, or are considering keeping in place, a minimum size threshold for dark orders. Although concerns raised by the increased usage of dark liquidity are being addressed in other jurisdictions globally, we believe it is important for the CSA and IIROC to recognize key differences in Canada's securities regulations. These include robust fair access rules, post-trade transparency requirements requiring attribution and "Best Execution" obligations for broker-dealers.

We note that Canada's fair access rules prohibit broker-dealers from operating dark pools that restrict membership to a single broker-dealer or a consortium of broker-dealers. This requirement (which we fully support) has greatly limited internalization possibilities; look no further than the portion of dark liquidity represented by internalization in jurisdictions without this protection. In addition, unlike the United States and Europe, attributed post-trade reporting of dark pool trades is mandated in real-time in Canada. The absence of these regulations explains rising concerns over the toxicity levels on the public exchanges in other jurisdictions. For example, the Trade Reporting Facility (TRF) in the U.S. reflects over the counter (OTC) trades (i.e. dark pool trades and trades executed in broker-dealer internalizers) but has no standardized counting methodology. This limited transparency makes it much more difficult for U.S. regulators to accurately measure dark liquidity volumes and inhibits a complete understanding of dark pools' impact on the public book. However, because of the post-trade transparency requirements in section 7.2 of NI 21-101, Canadian regulators are able to effectively monitor the impact of dark liquidity in Canada over time and, in turn, are capable to identify if/when any negative impact is realized. Finally, Canada's "Best Execution" obligation requires broker-dealers to diligently seek the most advantageous execution terms reasonably available for each client trade, which prohibits them from internalizing orders using dark pools unless the resulting price for their client meets the best execution obligation.

We therefore believe that Canada's current regulatory framework already provides significant protection against the growth of unproductive forms of dark liquidity and enables effective monitoring of dark liquidity volumes. Nevertheless, we propose the introduction of the following enhancements to fortify an already formidable regulatory framework:

- Mandatory disclosure of the operations of dark pools, including descriptions of allocation methodology and how dark orders interact with lit orders on their order books. Greater disclosure will enable both regulators and participants to better understand how dark liquidity is impacting market dynamics.

- The introduction of additional reporting requirements for broker-dealers and marketplaces to provide information on the use of dark orders, including what proportion of total trading is accounted for by dark orders. Additional reporting requirements will enable effective monitoring of the usage and impact of dark orders.

- The introduction of reporting conventions for dark liquidity and recognized standard metrics to measure best execution. This will provide a convention for participants to assess the contribution that dark liquidity is making to execution quality and the impact it is having on market integrity.

To summarize, given that the limited adoption of dark liquidity in Canada is not currently adversely impacting liquidity available or the price discovery mechanism, along with the presence of an existing regulatory framework that assures effective monitoring, we believe there is no purpose served in imposing constraints on its use at this time. While we would encourage the consideration of the three policy enhancements noted above, we recommend that the CSA and IIROC adopt a measured approach to

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dark liquidity regulation, implementing reforms only when and if the empirical data indicate they are necessary.

Chi-X Canada's Responses to Questions/Themes Raised in the Paper

What is Meaningful Price Improvement

Currently dark pools are permitted to accept orders at sub-penny prices, a practice this is not permitted for lit marketplaces. We support the CSA/IIROC position that UMIR minimum tick increments should be harmonized across all marketplaces and be used to provide meaningful price improvement where applicable (half tick increment when the spread is already at a minimum). As outlined in the Proposal Paper, the practice of sub-penny pricing allows for quote jumping and exponentially increases the costs associated with message traffic. We believe this proposed reform, in addition to leveling the playing field between dark and lit marketplaces, will help encourage posting of displayed orders by removing the incentive to post in sub-penny increments on dark marketplaces, thereby assisting the CSA/IIROC in accomplishing their stated objective of encouraging posted displayed orders.

Market models that exploit sub-penny orders can be best explained in the context of UMIR 8.1 *Client-Principal Trading* (CPT). CPT mandates that a participant must provide price improvement for orders that it receives for 50 standard trading units or less of a security with a value of $100,000 or less.[5] Markets that permit orders to be entered at small fractions of a penny enable participants to internalize smaller client orders at de minimis levels of price improvement while not being out of compliance with the rule. Combined with Canada's current support of broker preferencing, a formula is often created by broker-dealers to almost guarantee an on-exchange internalization. This is of particular concern given that order flow in Canada is highly concentrated and controlled by a limited few participants. The elimination of sub penny pricing will not mean that broker-dealers are unable to internalize client orders, but it will require that they do so only after providing meaningful price improvement. A natural consequence of this reform will be that by having to offer meaningful price improvement of one standard trading increment (or a half tick if the spread is already at a minimum size) fewer orders will be internalized at prices close to the NBBO. This, in turn, will result in more orders interacting with the NBBO and a wider variety of contra-side participants.

Should a minimum size threshold for dark pools exist?

We have concerns about the impact introduction of a minimum size threshold to qualify for an exemption from the pre-trade transparency requirements in section 7.1 of 21-101 may have on the market at this time. The rationale for this proposal seems to be predicated on the belief that current rules are insufficient to handle the potential adverse impact that dark orders may have to both liquidity and price discovery in the market. Justifying the proposal as a preventative measure would indicate that the need for reform is inevitable going forward, a view with which we disagree unquestionably since Canada's existing fair access and post-trade transparency rules make the inevitability of such a development far from certain. Given this uncertainty, and recognizing the unintended consequences that may result from proposals outlined in the Proposal Paper, we reiterate our recommendation to continue to monitor the development and impact of dark liquidity in the future and adopt adjustments when, and if, necessary. Of particular concern is that large block orders will migrate back to traders' blotters and lead to a resurgence in upstairs

[5] IOSCO, "Issues Raised by Dark Liquidity," October 2010.

trading. We believe that such a development would be regressive, as a great number of participants would be unable to interact with this order flow.

Should the posting visible orders be encouraged?

We are of the opinion that existing incentives to post visible orders are sufficient. Dark orders entered on displayed marketplaces lose priority to visible orders at the same price, and are not protected under the UMIR 5.2 Best Price rule currently in effect, nor will they be protected under the Order Protection Rule set to be implemented on February 1, 2011. In addition, the opportunity cost of posting an order in a dark pool may be increased since there is no regulatory requirement to connect to these venues. The decision to enter an order as either visible or dark is based on a participant's conscious trade off between potentially reducing market impact costs with the potential opportunity cost of missing a trade. As different investors have dissimilar trading objectives, it is important to offer the benefits of dark orders to all participants and allow them to evaluate this decision for themselves. Limiting choice interferes with the investor's ability to realize the full spectrum of trade offs between market impact and opportunity costs.

How should liquidity be exposed to the widest variety of contra-side parties?

If a minimum size threshold is introduced, any order executing against a dark order will signal that an order of at least the minimum size exists. Such information can then be used for gaming, leading to inferior execution quality for the investor using the dark order. In order to prevent gaming, qualifying dark orders will include minimum execution size conditions. This unintended outcome will restrict access to these orders by any other order that is below the minimum size. Consequently, we believe that the intent to expose these orders to more counter parties may, ironically, result in limiting the number of investors that have access to them.

What unintended consequences of a minimum size requirement should be considered?

Disadvantaging certain market participants by preventing them from benefiting from the unique characteristics of dark orders is an unintended consequence that should certainly be considered, in our opinion. For example, retail orders that do not qualify for the minimum size would be forced to post as visible orders, regardless of any order instruction directions given to the broker-dealer. In addition, investors that utilize algorithms to trade large orders would be disadvantaged. As noted above, given the adoption of algorithms, parent orders that would otherwise qualify for the exemption are divided by algorithms into smaller orders that vary in size. By restricting the opportunity for these orders to be entered as dark orders, market impact costs will increase and overall performance will diminish. Finally, if a minimum size is enforced, it could lead to fewer algorithmic orders being posted on displayed markets. With the enforcement of a minimum size requirement, the entirety of the larger order would sit on the dark book, lest it drop below the minimum size and eliminate the potential for any potion of the order to be routed to the lit market.

Another example of an unintended consequence of a minimum order size requirement is the impact on contingent orders. All-or-none orders and other orders of minimum quantity fill sizes that do not meet the minimum size threshold will be forced to be entered as visible orders. Forcing these orders to be visible will result in unintended locked and crossed markets, which would require the CSA and IIROC to develop news rules for handling orders resulting from this scenario.

Finally, if the CSA and IIROC were to impose a minimum size for dark orders, a related challenge would be the determination of the mandated order size. The minimum threshold must consider price and liquidity characteristics of different securities. For example, a 5,000 share minimum size for a $1 security does not represent the same market impact and contribution to price discovery as a 5,000 share order for a $100 security. Likewise, two orders of the same size will have different market impacts and make differing contributions to price discovery for liquid and illiquid securities. Recognizing these differences would require, at a minimum, a sliding scale. However, as liquidity characteristics of securities change over time, the right number yesterday may not be the right number for tomorrow, meaning the sliding scale would need to be dynamically updated to track changes over time. Needless to say, this would be complicated and challenging to implement, and selecting the wrong size for certain securities may result in unintended consequences for different classes of securities. In our view, this should only be undertaken if and when the benefit is warranted, and given Canada's current market structure, we do not believe that such a benefit exists today.

In conclusion, we recommend the postponement and thorough consideration of any measures that may restrict participant choice in their use of dark liquidity. We believe that given the limited evidence to support any notion that dark liquidity is currently adversely impacting price discovery, as well as the potential for unintended consequences, the CSA and IIROC should not adopt any major regulatory changes beyond those minor adjustments to the disclosure and reporting requirements for marketplaces and broker-dealers that we have proposed above.

We would like to thank the CSA and IIROC for the opportunity to respond to the Proposal Paper and welcome the opportunity to discuss our submission with the staffs.

Sincerely,

Chi-X Canada

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