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# AMR Associates Inc.

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Jan. 28, 2011

British Columbia Securities Commission  
Alberta Securities Commission  
Saskatchewan Financial Services Commission  
Autorite des marches Financiers  
Manitoba Securities Commission  
Ontario Securities Commission  
New Brunswick Securities Office  
Office of the Attorney General, Prince Edward Island  
Nova Scotia Securities Commission  
Securities Commission of Newfoundland and Labrador  
Registrar of Securities, Northwest Territories  
Registrar of Securities, Nunavut  
Registrar of Securities, Yukon Territory

Attention:

John Stevenson  
Ontario Securities Commission  
20 Queen Street West  
Suite 1900, Box 55  
Toronto, ON M5H 3S8

Madame Anne-Marie Beaudoin  
Autorité des marchés financiers  
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Kevin McCoy  
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Dear Mme. Beaudoin & Messrs. Stevenson, Twiss and McCoy

Thank you for the opportunity to comment on the Joint CSA/IIROC Position Paper, 23-405, on Dark Liquidity in the Canadian Market. The issues discussed in the position paper are significant ones in the debate about dark liquidity. Canada has developed a strong framework for alternative trading systems with better pre and post trade transparency than exists in other jurisdictions and it is important to analyze the impact of dark pools against the standards of liquidity, transparency, price discovery, fairness and integrity.

The development of alternative trading systems has created a far more complex trading environment than that which previously existed. It has brought many benefits but, with these benefits, have also come challenges and, indeed, some "unintended consequences". It is fair to say that regulators and participants in every jurisdiction that have a multiple marketplace framework have been "learning as we go". Regulators in all jurisdictions have had to assess and re-assess the impacts of these new markets on market integrity. I commend the CSA and IIROC for their ongoing commitment to create the best framework for our markets and for their efforts to engage the industry in debate and comment.

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In my work as a consultant, I specialize in advising my clients on how technology is transforming our industry and the business and regulatory impacts of changes in the investment process. Having done work for the CSA and IIROC in the past, as well as an assignment for the Australian Securities and Investment Commission earlier this year, I believe that I appreciate and understand the challenges of creating a strong regulatory framework. The comments expressed in this letter are my own personal views on the issues and do not represent the interests of any of my clients. I believe these comments present an objective view of the issues and come from an unbiased viewpoint.

## **Comments re CSA/IIROC Proposal on Dark Pools, 23-405**

In reviewing the position paper, it is critical to assess the purpose and role of dark liquidity in our markets. Institutional traders have always faced the challenge of finding liquidity without revealing information to the market that would result in negative market impact to them. Numerous studies have analyzed the cost of information leakage and market impact on the overall transaction costs of a trade. Historically, some might say that the specialists on the floor of the exchange represented the first dark pool since they frequently had information that was not posted on the published quote. Over time, institutional traders began to try and match orders in the "upstairs" market, which essentially was a dark pool. Both of these types of dark markets carried with them inherent information leakage. In recent years, with the advent of electronic trading, buy-side traders have also begun to use electronic tools such as algorithms or dark matching systems to find liquidity. Electronic dark pools (and dark order types in transparent markets) were developed as an alternative to enable traders to minimize information leakage and thus control market impacts costs.

Dark liquidity has provided a viable alternative for traders seeking to find new sources of liquidity with little market impact. There is no substantial evidence that dark trading has a negative impact on overall market quality and many believe that it has enhanced the liquidity of our markets. A recent article done by one of my clients, ITG<sup>1</sup>, concludes that, at the very least, there is no empirical evidence that dark pools harm market integrity.

Dark trading in this country currently represents a very small portion of trading. In 2010, less than 2% of Canadian market volumes traded in dark pools. This is also true in markets such as Europe and Asia. In the US, dark trading has become a much more significant portion of trade volumes (estimated at 12-14%) as dark pools have evolved to include systems designed to internalize retail client order flow. It is true that these dark internalization pools use the NBBO to establish their trade price, but the question that participants have started to ask is, "at what point does the price discovery mechanism become affected if a significant portion of public orders are not contributing to establishing the NBBO?". The inflow of many small retail client orders have always formed part of the price discovery process and when these orders are being routed away from the transparent markets, there may be a point at which the price discovery mechanism is no longer as robust as it might be. A recent article suggested the "tipping point" for the price discovery mechanism not being valid was when about 40% of the flow was being routed elsewhere. The NYSE currently estimates that as much as 60-65% of their order flows are coming from HFTs, not client orders.

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<sup>1</sup> ITG Insights Newsletter, Volume One, Issue Ten, Dec. 8, 2010: *Are We Missing the Evidence in the Global Dark Pool Debate?*

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I do not believe dark pools currently represent an issue for market integrity in Canada. However, the potential for internalization of retail order flow does represent a concern for the price discovery mechanism. It is a particularly important issue in this country given that we have a relatively small market which is dominated by a few very large players who control a significant amount of order flow. In assessing the proposals put forth in the position paper, it strikes me that this is the crux of the issue regarding dark liquidity.

## Price Discovery & Internalization

- Although dark pools are currently a small percentage of market-share in Canada, it is prudent to prevent against the potential for large dealers to internalize a large portion of order flow – if we consider that they could internalize as much as 40% of retail client flow, what would that do to the price discovery mechanism? It would give us a market not unlike what we see in the US – where the lit markets are dominated by HFTs and characterized by high volatility. Dark pools still trade based on the NBBO but is that NBBO being established by the appropriate influence of both small and large investor when a large portion of retail flow routed away from transparent markets and internalized?
- Internalization of client order flow is not necessarily a bad thing when it is done to reduce costs and both clients receive price improvement by trading with price improvement, perhaps at the mid-point. What is not beneficial to client fairness is internalization of client order flow when a dealer provides minimal price improvement and trades against his own client order flow for profit. If the dealer is providing only sub-penny price improvement by jumping the quote and essentially making the spread on client orders, this is simply a thinly veiled way of getting around current UMIR order exposure and internalization rules.
- Further concern about internalization relates to whether or not the individual investor is being fairly treated – which is, of course, is one of the primary objectives for regulators. If dealers can make money by selling their client flow to wholesalers or by trading it on a proprietary basis, then this is an inefficient market and clearly the client is NOT getting the best price possible when there is profit incentive for dealers.
- I know of no other business where a dealer can act as agent for a client and charge a commission while at the same time, trade against that order and make a profit. This is fundamentally unsound from an ethical point of view and not in keeping with either fiduciary responsibility or the principles of Best Execution.

So – assuming that one wishes to establish a regulatory framework that allows for dark pool trading but also allows for a strong price discovery mechanism and limits internalization – what are the best ways to accomplish this?

## Minimum Size Threshold:

- If dark pools are intended to enable institutional investors to match large orders with minimal market impact, a minimum size threshold would seem consistent with the purpose of dark pools. While the suggested 50 board lot size is in line with the UMIR order exposure and internalization rules, those rules were established when average trade sizes were much higher. Given the current average trade sizes of 300-400 shares, the 50 board lot minimum may be unrealistic.

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- A concern about the minimum size threshold is that it will severely limit algorithms from placing passive orders – and algos are one of the best ways for institutional traders to manage large orders and control market impact and information leakage. So again – perhaps the minimum size should be far less than originally suggested; if the minimum size were 10 board lots, then algos would have better options for placing passive orders.
- Light/dark priority – I would agree that visible orders should ALWAYS have priority over dark orders matching.

## Meaningful Price Improvement

- Minimum price improvement – I would strongly agree that there should be meaningful price improvement and would agree with your proposed structure of at least one tick (unless the spread is one tick, then mid-point).

## Suggested New Rule re Price Improvement and Internalization

- Perhaps of greater importance than the minimum size issue is the issue of preventing internalization. One suggestion would be to include in the proposal that client-principal crosses in a dark pool must be done at mid-point – this virtually takes away the profit incentive for dealers to trade against their client flow in a dark pool and would ensure that they are only sending orders into dark pools when it is in the best interests of the client. If this were the case, then the minimum size threshold may not even be needed.

The questions raised in the CSA/IIROC position paper are important ones for participants to consider and healthy debate on these issues has great value. The consultation process will enable regulators to achieve the best possible conclusions for our markets.

Thank you for your time and consideration of the comments expressed in this letter.

Yours truly

AnneMarie Ryan  
President  
AMR Associates Inc.