June 16, 2011

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

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Re: Request for Comments on the Canadian Securities Administrators (CSA) Proposed Amendments to National Instrument 21-101 *Marketplace Operation* and National Instrument 23-101 *Trading Rules*

Dear Sirs/Mesdames:

Chi-X Canada ATS Limited ("Chi-X Canada" or "we") welcomes the opportunity to provide comments on CSA's Proposed Amendments to National Instrument 21-101 *Marketplace Operation* ("NI 21-101") and National Instrument 23-101 *Trading Rules* ("NI 23-101") ("Proposed Amendments").

We commend the CSA on this initiative to better align the requirements of Exchanges, QTRSs and ATSs and to introduce new information transparency requirements for marketplace operations. Given the similarity of trading activities, services and functions offered by Exchanges and ATSs, the need for discrete regulatory requirements for each no longer exists. We strongly support the proposed transparency requirements for marketplace operations that will require disclosure of each marketplace's market mechanics, functionality and execution rules. We believe that providing information about marketplace operations is essential to helping trading participants understand their trading options and how their orders interact with each marketplace on which they trade.

Our specific comments to Proposed Amendments are provided below:

Specific Comments

Marketplace Reporting Requirements

The Proposed Amendments define a "significant change" as one that "could significantly impact a marketplace, marketplace participants, investors or the Canadian capital markets."[1] The rationale for the 45-day reporting requirement before implementation is to provide the CSA with sufficient time to assess any potential impact that a change may have. We commend the CSA for providing explicit guidance regarding what constitutes a significant "change". Whereas today Companion Policy 21-101 CP ("21-101CP") defines a significant change to be "any change to the information in certain Exhibits of Form 21-101F1 or Form 21-101F2", the Proposed Amendments include an itemized list of changes that are considered significant by the CSA.

We believe it is important that the CSA is provided sufficient time to assess the impact of a significant change in order to understand any potential impact and identify any market integrity concerns that might be raised by the change. However, we also believe that it is important to limit the scope of what constitutes a significant change to those that truly represent a significant impact to a marketplace, marketplace participant, investors or the Canadian capital markets. Requiring a 45-day reporting period for changes that do not significantly impact these stakeholders unnecessarily delays business objectives and can interfere with a marketplace's ability to service its customers.

The Proposed Amendments also include changes to the reporting requirements for "non-significant" changes. Whereas today these changes are required to be reported within 30 days of the end of each calendar quarter in which they occurred, the Proposed Amendments will require information about these changes to be filed immediately. This change of practice will ensure that the CSA is notified of any change before it is implemented and be positioned to determine if a longer review may be necessary. Consequently, we believe that several of the changes outlined in the Proposed Amendments as "significant" should be evaluated on a case by case basis to determine their appropriate categorization. Should the CSA determine that a longer review is warranted for any particular change, it can classify the change as "significant" and trigger the 45-day reporting requirement. However, if there are no issues raised and impact to stakeholders is deemed limited, the change should be eligible for approval without delay. This approach will allow determinations to be made based on substance instead of form. For example, a marketplace request to open for trading before all other marketplaces should be considered a significant change, but a marketplace request to align its trading hours with others should probably not. We highlight a few of the listed significant changes in Proposed Amendments where factors such as a previous precedent existing in the market should be considered in making a determination:

- Trading hours;
- Types of securities;
- Types of participants;
- Order types;
- Certain other trading functionality such as wash trade prevention, cancel on disconnect etc;
- Technology changes made to hardware and infrastructure.

We also note issues raised by categorizing changes to affiliates as significant changes. Marketplaces with multi-layered ownership structures may have tens or even hundreds of affiliates throughout the world, making it difficult to know ahead of time when changes are made. We therefore suggest that only changes made to domestic affiliates be classified as "significant" changes requiring a 45-day notification.

[1] Proposed subsection 6.1(4) of 21-101CP.

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Revisions and Updates to Form 21-101F3

We support the adoption of uniform regulatory requirements for ATSs and Exchanges and therefore support the requirement for all marketplaces to file Form 21-101F3 ("F3") on a quarterly basis. The F3 serves as an effective reporting tool for the CSA to better understand developments in marketplace operation and services. However, although we are not opposed to providing information on orders and trades per se, we question whether the marketplaces are best positioned to provide this data, as we believe that reports on order and execution activity should be generated by IIROC instead. Having a single, consolidated source for reporting will minimize potential discrepancies among marketplaces and, in turn, prevent a distorted view being presented to CSA. In addition, unlike changes made to the F3 that require a formal rule amendment and public comment period, IIROC is able to provide the CSA with customized reports on an "as needed" basis. The information included in the F3 should be information that is specific to each marketplace and unavailable to IIROC such as reporting on the number of system outages that occurred in the quarter and information about co-location services.

Notification Threshold

When the ATS Rules were introduced in 2001, exchanges were viewed as more critical to the capital markets than ATSs, thereby warranting additional regulatory requirements. Since then, however, the similarities and differences between exchanges and ATSs have been more clearly understood, with initiatives like the Proposed Amendments now underway to apply consistent requirements to both. As a result, although we do not have a specific objection for lowering the notification threshold level from 20% to 10%, given recent developments, we question the value that a notification reporting requirement provides.

The initial rationale for the notification requirement was to alert the CSA when an ATS captured a significant percentage of market share and, in turn, trigger a review of the ATS "because each of these thresholds may be indicative of an ATS having market dominance over a type of security, such that it would be more appropriate that the ATS be regulated as an exchange."[2] Given the harmonization that has occurred between the regulatory requirements for Exchanges and ATSs, the remaining regulatory differences applying to these two types of marketplaces generally relate to listings, regulatory responsibility and governance. It is unclear how forcing an ATS to become an Exchange or applying certain terms and conditions related to these areas would serve the public interest unless an ATS was planning on listing issuers or taking on a regulatory responsibility. In addition, it is redundant to require an ATS to notify the CSA if a threshold is met or exceeded. The official market share metrics used to evaluate threshold levels are produced by IIROC, which provides the data to the CSA and all marketplaces at the same time. As a result, the CSA is effectively notified by IIROC if a threshold is met or exceeded; requiring a marketplace to also inform the CSA duplicates this process.

New Guidance on Order information being provided to SORs

Consultation Paper 23-404 *Dark Pools, Dark Orders, and Other Developments in Market Structure in Canada* ("Consultation Paper") asked several questions about certain information being provided to smart order routers by marketplaces. These questions included whether a marketplace should be permitted to select which destinations are able to receive indications of interest, and whether a marketplace's smart order router should be able to take into account hidden liquidity posted on that marketplace in making routing decisions. Whereas the majority of respondents to the Consultation Paper were opposed to marketplaces being able to provide IOIs to select destinations, the majority of respondents were in favor of a marketplace taking into account dark liquidity on the marketplace when making routing decisions. In addition, many of those who expressed opposition did not take issue with a marketplace router taking account dark liquidity in routing decisions so long as all visible liquidity is exhausted at that price level

[2] Notice of Final Rules: Alternative Trading System; Companion Policy subsection 3.4(6), November 2001.

before a dark order is executed. In CSA/IIROC's Position Paper *Dark Liquidity in the Canadian Market* ("Position Paper"), it was suggested that 1) mandatory price improvement should be offered to all orders—with the exception of other dark orders—executing against dark orders, and 2) that dark orders must meet a minimum size threshold. If adopted, we believe this would ensure that visible liquidity would be prioritized over dark liquidity at the same price level and would address a main concern raised by commenters. Consequently, it is likely that there would be a larger majority of respondents in favor of this practice if the question was asked today.

The Proposed Amendments specifically include a new requirement that a marketplace that sends IOI information to a selected SOR needs to consider the extent to which such information should be sent to other SORs in order to meet its fair access obligations. However, there is nothing specifically mentioned about a marketplace smart order router taking into account dark liquidity posted on its book in making routing decisions. If our understanding is correct, the proposed change to the pre-trade transparency requirements from "orders displayed *on* a marketplace" to "orders displayed *by* a marketplace" will prohibit a marketplace smart order router from taking into account hidden liquidity posted on its own market without triggering the pre-trade requirements. Given the support of commenters for this practice, we are surprised that no policy rationale has been provided for this change.

In Chi-X Canada's response to the Consultation Paper, we outlined four major benefits that are derived from a marketplace smart order router taking into account dark liquidity on its book when making routing decisions:

1. Price improvement is offered to contra-side orders entered on the marketplace (assuming execution fees are not prohibitive) that are executed against dark liquidity at prices better than the next best displayed available order;
2. Better execution is offered to clients without risking the possibility of gaming or front running as information is not shared with any third parties;
3. The ability to consider hidden liquidity for those interested in interacting with it serves to mitigate the opportunity cost associated with blindly "sourcing it;" and
4. More efficient routing generates less message traffic.

Recognizing these benefits and the fact that a majority of commenters supported this practice, we question CSA's rationale for this change.

Definition of a Marketplace

The Proposed Amendments provide additional clarification regarding the definition of a "marketplace." Specifically, Part 2.1(8) of 21-101CP recognizes a dealer using a "system that brings together multiple buyers and sellers using established, non-discretionary methods to match or pair orders with contra-side orders outside of a marketplace and which generates trade execution through routing of both sides of a match to a marketplace as a cross would be considered to be operating a marketplace". This guidance clearly requires broker dealer internalization systems to be regulated as marketplaces, which in turn has important implications for the debate surrounding broker preferencing.

The unique market characteristic of broker preferencing has become somewhat controversial in recent years. Chi-X Canada has been a vocal opponent in this debate, arguing that this mechanic offers an unfair advantage to large participants and, in turn, serves to inhibit quote competition and price discovery. In our response to the Consultation Paper, we outlined the following distortions created by broker preferencing:

- A disincentive for those who are not customers of the preferenced dealers to provide liquidity, thus adversely impacting quote competition and price discovery;
- The appearance of a two-tiered market, thereby undermining investor confidence;

- The potential to undermine market integrity by allowing market structure opportunism to trump the ability to deliver value;
- The creation of an inappropriate incentive for liquidity providers to become customers of the large preferenced dealers;
- An incentive for large brokers to forgo investing in technology or product in favor of building market share by capitalizing on their size and captive order flow (e.g. retail or institutional); and
- The ability to "sell" a "first look" at incoming orders without having to take on the risk of "price setting".

Although many participants recognize fairness concerns are raised by allowing an order to jump the queue through broker preferencing, a competing concern was expressed by commenters: if broker preferencing was removed from the market, it may result in dark pools being established by dealers to internalize orders, therefore reducing transparency. Given the clarification by the CSA that the definition of a marketplace includes internalization systems, and that dark liquidity reforms have been proposed that will constrain dark orders to a minimum size and mandate price improvement in most circumstances, this concern has been addressed. We therefore strongly encourage the CSA to move to introduce new reforms that will eliminate this unfair practice in the Canadian market.

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

Sincerely,

Chi-X Canada

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