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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

Re: Request for Comments — Proposed National Instrument 21-103: Electronic Trading and Direct Electronic Access to Marketplaces

Dear Sirs and Madams:

Over the past 3 years, our firm has acted as de facto market makers on between 5% - 15% of total TSX listed securities although we do not participate in any formal liquidity provision programs. Our strategy has been to maintain a near "zero footprint" in the marketplace and to interact with retail and institutional flows (the real market) as gently as possible. We maintain a 90% passive-active trade ratio.

Having started as a junior in the business on the TSX trading floor as it was in its final days, I have had the opportunity to witness the full transition to electronic trading in Canada. Then, as today, there were those who could no longer keep the competitive pace and who complained without good reason together with those who had legitimate concern about the integrity of the marketplace. As such, I recognize that today, as was the case then, I must try to speak from a standpoint of clarity and non-bias and attempt to speak on behalf of the market as a whole as opposed to on behalf of myself alone.

Over the last year, we have seen a steady and exponential deterioration in the market price discovery mechanism to such a degree that it is simply becoming too risky for firms like ourselves to hold ourselves out to the market. This is equally true of retail and institutional participants who, increasingly, have only to lose by placing their order flow passively in the book and showing their hand to the market. Market makers like ourselves and retail / institutional traders are slowly disappearing from the top of book and only transient, small bids and offers remain. Most retail and institutional traders are now using the 'bypass' marker as a default in order to bypass the noise at the top of book and hence normal client orders as well as market orders are executing at disparate and incongruent price levels at various prices deep in the book. Trading in many of these instruments has become wild and the jagged nature of the stock charts attests to it. Tighter spreads are in many ways an illusion of what are rather larger 'real' spreads. Real passive liquidity and real passive participation is disappearing from the marketplace.

Canada's equity markets appear to be advanced, efficient marketplaces but there are fundamental issues around market regulation and enforcement. New marketplaces and new technologies are being introduced at a feverish pace without an understanding of their impacts from a governance standpoint. In the presence of technological confusion and the absence of new understanding and new regulation, a number of market participants are able to use new technologies as a competitive weapon in a number of grey areas where enforcement has been difficult to achieve to date. This has lead to a regulatory asymmetry whereby the most risky and least compliant participants can trade without restraint. This puts more conservative and risk-aware traders at a disadvantage and leads to a crowding-out of the more responsible players. In fact, this end-game is being pursued as an active strategy by the most disregarding of participants: by wreaking havoc and destroying the marketplace, they are able to gain competitive advantage and to assert themselves further. Hence, we are well within a downward spiral of illusionary liquidity and non-compliance. In order to maintain and to restore the integrity of our markets, it is crucial that any new regulations be successful in preventing or controlling irresponsible activity while encouraging bona fide investing and real market making activity.. Toxic participants are very much aware of the changing landscape to come and are currently accelerating their push to try to corner as much of the market as possible ahead of any tightening of the regulatory regime. The industry is deadly slow to react and we are currently well on course to doing "too little, too late."

Following are some of my comments on the Direct Exchange Access regulation amendments:

1. Credit checks – open orders and fills

The DEA proposal is constructive in that for the first time it mandates pre-trade credit checks. The wording is vague, however, and may not materially change the behavior we see in the market. We see boutique brokers with very limited capital allowing clients with apparently small deposits to put an unlimited number of orders into the market, with very limited risk management. There seems to be no controls over the risk imposed by having far more orders in the market than the client or their broker could possibly pay for. In the case of a technology problem, whereby thousands of orders could be entered at erroneous prices, a rather large systemic risk to the market would be posed. The counter party risk is incalculable. Currently, small brokerages rely on the capital base of their carrying broker to justify this type of activity. However, since the carrying broker does not have a direct relationship with the end client, it is not in a position to manage this type of risk. The rules should set a certain minimum standard of capital & capabilities to support unfettered and unlimited market access.

2. Messaging Rates and Messaging used as a Competitive Weapon

The DEA rule is silent on what constitutes an unacceptable rate of quoting. Quote stuffing is commonly blamed as a partial cause for the Flash Crash, yet our DEA rule seems totally focused on executions rather than on orders in the book. Similar to the suggestion that the risk of open orders must be more explicitly managed, at a certain point excessive quoting becomes manipulative and should be treated as such. Guidance on order to trade ratios, or at least a test to evaluate if order activity is appropriate in the context of the trader's strategy and the order books that they participate in, seems appropriate. In short, we see many participants who place multiple orders on various securities in which they have no current position. They do so day in and day out yet have never perhaps even made one conclusive trade in the security. Moreover, there are also those participants who use messaging as a 'noise' creating strategy to purposely interfere with other participants and to blur quotes in order to impede true market price discovery. This needs to be spelled out as outright illegal as it is making a mockery of our professionalism as an industry. Many markets around the world have moved to specific order-to-trade ratios above which fees are imposed specifically to correct the situation and to restore efficient messaging-to-trade equilibrium to the marketplace. This needs to be implemented immediately in the Canadian marketplace to combat the trend of disappearing liquidity before it is too late. Our firm spends a great deal of energy on reducing its messaging and rendering its flow more efficient while we see other pariah participants in the marketplace who are expending tremendous amounts of energy to do the exact opposite: to increase toxic messaging and to purposely disrupt quotes. Many brokers are self-regulating in this regard in the absence of clear guidance while others use the lack of clear guidance in order to simply close a blind-eye. We need a level playing field for the industry immediately.

3. Probing, Interference and Model Based Trading

We have seen marketplaces in the United States move to ban so called 'flash orders', yet we fail to recognize that a number of probing-type and interfering-type orders are entered into our market every day. A number of participants have come to understand that true competition in the marketplace has evolved away from single stock-to-stock competition and into a more 'model-based' style of competition. On the sly, many participants are using manipulative and deceptive orders to purposely interfere and dislodge existing market models or other participants in the marketplace so as to be able to strengthen their own competitive placement within the space. There must be an attempt made to understand 'model-based' competition and interference and injurious tactics used by participants to gain a competitive edge or to inflict harm on other participants. Many toxic participants are using a strategy of "dumping" as it is referred to in international trade; that is the strategy of selling goods at below cost for a certain period of time in order to crowd out the competition to then be able to secure a market monopoly in the future. This tactic is highly scrutinized in international trade circles and should be in our markets as well. We see participants entering into losing trades for extended periods of time simply to interfere and to harm other market participants. The goal is to displace tradability in a number of securities that are part of the competitor's model in order to injure the competitor financially such they are forced to withdraw their model from the marketplace so that the instigator can then emerge with a monopoly in the trading of the securities / model of interest. This is achieved by:

- increasing messaging in securities exponentially, forcing quotes to gyrate for a good portion of the trading day
- destroying top of book visibility by entering a series of insignificant orders at various price levels such that the entire perceivable market book becomes completely irrelevant
- entering and cancelling a good number of orders with a great deal of frequency to blur and distort pricing
- entering orders to specifically interfere with other participants' orders
- decrypting other participants algorithms and writing specific code-breaking algorithms specifically targeted to break other algorithms regardless of whether the result would be positive for profitability or not. Many times, the resulting "algo-breaking" codes are written simply to interfere and perhaps not even to trade (trading is a secondary or even non-consideration of the strategy).

The intent of all of this is to debunk and to chase out competition in the most malign of ways. This happens daily on our markets and highly skilled traders and programmers are trained to work on these tasks. This is the other market that is interacting with the real market. This is a current new frontier and grey-zone which must be clearly addressed by regulation, become detectable and investigateable and enforceable by market surveillance.

The reason that this has been going on unnoticed is that traditional compliance and enforcement is geared towards stock-by-stock evaluation mechanisms. Under the old lens of what constitutes appropriate behavior, certain orders may seem normal and passable when analyzed on a single security basis but when these order types, their activity and their intent are analyzed over a larger range of securities, their probing, manipulative and interferent nature and intent is quickly discernable. Model based trading and manipulation needs to be developed and understood as a macro strategy and as a science. It needs to become discernable, investigateable and enforceable. Participants must be able to bring such complicated cases forward to regulators and have them understood and investigated. Market Surveillance needs to be accountable to participants with their findings and needs to have the ability to pass judgment on bleeding edge situations that are perhaps not clearly defined in the rule book. In an increasingly complicated environment, participants need to be held accountable to the spirit of the rules at all times and not to the lowest standard that is hard coded into the rule book.

4. Custom algorithm issues

While an algorithm certification regime may not be practical, there needs to be even more specific requirements to distinguish between widely-used, tested and off-the-shelf algorithmic technology provided as canned solutions by vendors and brokers versus custom code developed by or for a DEA client. Brokers should be required to distinguish between these two types of algorithms and have a robust regime to test and audit custom technology that is used under their exchange memberships for appropriateness, governance and risk minimization. As soon as a client is allowed to write even the slightest bit of custom code to the market, there needs to be the understanding that this is a privilege and a responsibility to be work in communion with other participants in a process of fair market discovery and not a carte blanche to attempt to harm other participants and to destroy the efficiency of the marketplace.

5. Identifying DEA participants

Allowing regulators to decode the identity of a DEA participant makes perfect sense and would clearly serve a useful surveillance and investigative purpose. Moreover, in the case of a DEA participant who houses multiple traders, it should be necessary for the client to provide the broker with a daily up-to-date list of all those traders who will be entering orders into the system (ie, the traders).

However, providing marketplaces with the direct identity of clients is dangerous, unless certain obligations are placed on them. Marketplaces are no longer utilities – they are profit seeking corporations. As such, they could use this information for marketing and competitive purposes. Moreover, marketplaces could discriminate against certain types of customers, either for their own benefit or for the benefit or a preferred client. Examples of this include limiting participation in Alpha's Intraspread facility to retail clients and the ability of odd-lot dealers to cancel fills when they feel that the participant's activity is not a traditional retail oddlot investor. If marketplaces are able to electronically distinguish between classes of traders, without regulatory guidance, they could pick and choose which clients can access which products. This has dangerous implications for market integrity.

6. Retail vs. Institutional

It is important that non-institutional traders are not discriminated against and continue to be able to make use of Direct Exchange Access. Capital markets have had a long tradition of providing access to "locals" – sophisticated individual traders that are neither institutional money managers nor retail investors. These "locals," add liquidity for investors by making a more or less continuous two sided market in securities that generally do not have other market makers.

On the flip side, a number of small and aggressive participants are allowing unfettered DEA access to a number of very poorly prepared, low qualified and under capitalized clients who have no formal experience or training in market making. Many of these new entrants also have no formal industry training or course preparation (CSC, Trader Training Course, continuing education) and hence have no respect for our markets: they view the entire situation as a virtual video game where the ultimate end goal is to win and where there are no standards to be respected. Unfettered access to very sophisticated tools is given to them too easily and hence they view them as competitive tools to be used as weapons in the video space and not as order execution tools to facilitate order entry. This is fundamentally confusing the issue and decimating the standards.

In the absence of a class to define the "local", limiting DEA access to institutional investors would have a negative impact on Canada's equity markets.

- Market-making services would be exclusively provided by foreign participants. Foreign wholesale market makers already have a significant advantage in being able to repurpose strategies and technologies developed for much bigger markets, like the US or UK, to the smaller Canadian market. Further disadvantaging "locals" by limiting their access would drive this important function out of the country, diminishing the talent pool in trading and trading related service industries. Perhaps more importantly, Canadian regulators would have less ability to control this type of trading when it is conducted from outside our borders.

- Individual traders tend to trade through a single executing and clearing broker. This puts the broker in a much better position to view the trader's risk holistically and to manage it effectively. This is not possible with institutional investors who typically use Delivery Against Payment accounts where the executing broker has no insight as to the client's true activity or risk picture. Allowing DEA for institutional Delivery-Against-Payment type accounts is therefore risky since the executing broker cannot evaluate position or portfolio risk. Therefore it makes more sense to ban DEA for DAP accounts and to limit it to clients that custody their accounts with their executing broker.

In conclusion, I feel that it is important to continue to evolve with technology and the marketplace, however, in a steady and controllable fashion. Sound analysis and well-designed regulation must go ahead of technology and not the other way around. I thank you for taking the time to process my suggestions, and am willing to meet with CSA staff at any time to discuss my comments in greater detail.

Sincerely,

John A. Passalacqua
President
ExpoWorld Ltd.