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To: All Canadian Securities Administrators and IIROC, via e-mail

May 30, 2019

Re: Internalization within the Canadian Equity Market

Dear Sirs and Mesdames:

TD Securities welcomes the opportunity to comment on the Joint CSA/IIROC Consultation Paper 23-406 *Internalization within the Canadian Equity Market*.

TD Securities is a leading securities dealer in Canada and a top ranked block trader in Canadian equities and options based on dollar value and shares traded. TD Securities also acts as the executing dealer for TD Waterhouse, the largest direct investing brokerage firm in Canada.

Internalization of order flow is a topic that has been debated globally throughout the history of markets. The core Canadian order matching rules were developed between the late 1980s and mid 1990s as the TSX transitioned from floor trading to electronic systems. We welcome the CSA/IIROC initiative to revisit this discussion as trading technology continues to evolve.

Market models for internalization vary widely across equities, foreign exchange, fixed income and derivative products. For equities specifically, different approaches have been taken by Canadian, US, European and Asia/Pac regulators. Canada is unique as the only major region without off-marketplace trading facilities. Internalization frameworks require a balance to be struck across various market participants and every model creates some form of a trade-off between best execution and market quality.

Question 1: How do you define internalization?

We view internalization as any trade where the same dealer represents both the buy side and sell side of the transaction, whether the trade is client-client or client-principal.

The role of a dealer extends beyond simply acting as a gatekeeper and providing marketplace access to clients. Two of the primary functions of a dealer are:

- soliciting interest for client orders and matching client buyers with client sellers as agent, and
- providing liquidity to clients as principal.

We recognise these functions may overlap in some respects with the role of a marketplace. The debate on internalization centres around how to enable dealers to source client interest and provide capital to client orders while also supporting price discovery and liquidity on public markets.

Question 2: Are all of these attributes relevant considerations from a regulatory policy perspective? If not, please identify those which are not relevant, and why.

We agree that these key attributes of a market continue to remain relevant from a regulatory policy perspective. We believe the key attributes should be applied to the entire market ecosystem to recognise the dealers' role in contributing to market quality rather than being limited to public marketplaces only.

Question 3: How does internalization relate to each of these attributes? If other attributes should be considered in the context of internalization, please identify these attributes and provide rationale.

Internalization plays an important role in a market through the sourcing of contra-side interest and provision of capital to client orders.

The internal liquidity within a dealer improves the capacity of the market ecosystem to absorb client orders and improves the immediacy of execution relative to public marketplaces, where liquidity may be thin or impacted by quote fade.

Under Canadian rules all internalized trades are printed on public marketplaces which contributes to transparency and price discovery. Other regions allow for internalized trades to be printed off-marketplace to a trade reporting facility. This model has some advantages in that market share metrics are more comparable across marketplaces and it simplifies the use of bypass markers. We would be supportive of moving to an off-marketplace trade reporting model if transparency was not affected.

Internal dealer liquidity acts as a buffer on market impact for larger orders and improves price discovery by minimizing unnecessary price displacement.

All dealers operate under the same ruleset and clients have a choice of dealers for order execution which supports fairness and market integrity.

Question 4: Please provide your thoughts on the question of the common versus the individual good in the context of internalization and best execution.

We think a balance needs to be struck between the conflicting goals of best execution for individual orders and supporting liquidity and price discovery on public markets, but in the context of a global market for order flow.

We recognise that global market participants measure their execution quality on an order-by-order basis and can choose between either the Canadian or US market to trade interlisted securities. If we focus entirely on the "common good" and sacrifice execution quality on individual orders, we risk losing global flows into Canada and hollowing out the Canadian commons.

Question 5: Please provide any data regarding market quality measures that have been impacted by internalization. Please include if there are quantifiable differences between liquid and illiquid equities.

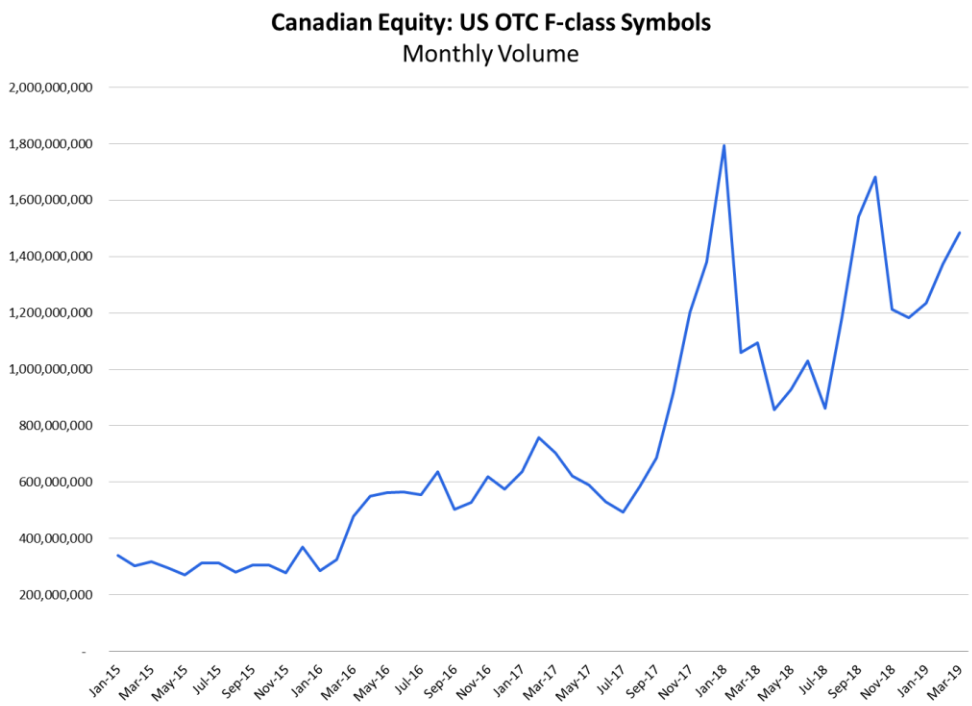
It's difficult to measure the impact of internalization on market quality without a formal data study including test and control groups, but the US market can act as a proxy for a more liberal internalization model.

The US market has enabled internalization in multiple forms. Regulation ATS allows dealers to create private liquidity pools to match internal flows before sending the residual orders to public markets. Virtually all US marketable retail flow is internalised by wholesalers away from the lit book. We estimate over 50% of US volume is internalised (40% on FINRA Trade Reporting Facilities and 10% on public marketplaces) compared to less than 25% in Canada.

The US market is the deepest and most efficient equity market globally, with lower market impact and lower overall transaction costs than any other region. It is hard to say if US market efficiency is a result of its liberal regulatory framework, but the high level of internalization does not seem to harm market quality measures compared to Canadian equities which trade in a more conservative market model.

The Canadian equity market does not trade in isolation from the US. We have 184 interlisted symbols with overlapping listings on Canadian and US primary exchanges. These interlisted symbols represent roughly half of the total value of equity trading in Canada. When including US trading volumes, the North American market for these interlisted securities is double the size of the Canadian market.

In addition to the primary interlisted symbols, there are close to 2,500 Canadian securities available for trading in the US market as over-the-counter F-class symbols. This set has grown from roughly 1,500 securities in 2015 and now covers virtually the entire Canadian tradable universe. US trading volume in these F-class symbols has grown by a factor of five over the past four years, from ~300 million shares per month in 2015 to ~1.5 billion shares per month this year.[1]



The US OTC market enables pure internalization of Canadian securities, where trades may be printed by dealers or market makers directly to the US Trade Reporting Facility. This pure internalization model has been successful in attracting global trading volume in Canadian securities away from the Canadian market.

[1] *Source: Bloomberg*

We regularly review quality of execution in the US and Canada, and we track market quality measures such as:

- Price Improvement (relative to the initial quote at time of order entry)
- Effective Over Quoted spreads (actual execution level as a percentage of initial quoted spread)
- At or Better % (percentage of orders executed at or better than the initial quote)

In all metrics the US market ranks as having higher quality execution than Canada, which may be attributable to the greater level of dealer liquidity made available through internalization.

Question 6: Market participants: please provide any data that illustrates the impacts to you or your clients resulting from your own efforts (or those of dealers that execute your orders) to internalize client orders (e.g. cost savings, improved execution quality) or the impacts to you or your clients resulting from internalization by other market participants (e.g. inferior execution quality/reduced fill rates).

Our clients benefit from internalization though higher fill rates on passive orders, reduced market impact on marketable orders and lower indirect cost of execution through savings in marketplace fees.

Internalization by other market participants also benefits our clients through reduction in adverse selection. We measure order toxicity in the Canadian marketplace and note that other dealers generally have a larger representation of active HFT orders with high short term alpha. Broker preferencing helps to contain these orders within the same dealer and reduces the odds of adverse selection for our clients.

Question 7: Please provide your views on the benefits and/or drawbacks of broker preferencing?

Broker preferencing benefits the Canadian market by encouraging liquidity to be posted on public marketplaces compared to the alternative US model of enabling internalization through private dealer pools and retail wholesaling. Canadian broker preferencing also encourages client-client matching, unlike the US model where active retail orderflow is absorbed by wholesalers rather than being matched with resting client orders.

Roughly 65% of our Canadian active retail volume trades with other dealers. In terms of the 35% of our active retail volume that is internalized, the large majority of this is represented by retail clients matched on-marketplace with other retail clients. **The primary beneficiaries of broker preferencing in Canada are retail clients.**

Some market participants are recommending to remove broker preferencing for orders of 50 standard trading units and under. If this proposal is passed, the negative impact will primarily be borne by Canadian retail clients.

In the US model, close to 100% of marketable retail flow is internalized by wholesalers and does not interact with either other dealers or other retail clients. We see the Canadian broker preferencing model as being a more balanced approach to internalization which supports public liquidity, public price discovery and broader access to order flow than the US model.

In the absence of broker preferencing the most frequently suggested order matching model is price-time priority, where same-price orders are filled first-in first-out based on resting time in queue. We have concerns that a pure price-time model will grant a sizable advantage to high frequency trading firms. Under a price-time model, the first dealer to establish a price level or the second dealer to join a price level will capture the majority of fills. A price-time model encourages an arms race in speed/latency which will result in one or two US HFTs dominating the Canadian market and will harm the quality of execution for our retail clients by lowering their passive fill rates.

A frequent criticism of broker preferencing is that resting orders are frequently "traded around" by dealer crosses. We note that without broker preferencing the problem of being traded around is still unavoidable in a multiple marketplace environment, where trades may occur on a marketplace away from where the order is resting. In a pure price-time model, the complaints of being "traded around by broker preferencing" would be replaced by complaints of being "traded ahead by HFT orders with higher queue priority" or "traded around on other marketplaces."

Broker preferencing plays an important role in meeting best execution for client orders and in reducing execution costs. If we have a marketable client order and a passive client order at the same price, we can achieve best execution for both clients by matching the orders rather than trading the marketable order with another dealer and leaving the passive client unfilled. Trading the active side with another dealer would be harmful to our passive client, who would miss an opportunity to be filled and may be exposed to a higher cost to complete the unfilled balance of their order. Matching active and passive orders also reduces the overall cost of execution for a dealer by balancing active fees with passive rebates rather than being exposed to the active fee alone.

Without broker preferencing, dealers would be incentivized to find other means to achieve the same best execution outcomes for their clients. We think this would lead to a more complex market with higher technology costs but ultimately limited changes to the level of internalization.

The European experience with MiFID II is a cautionary example. A policy goal of the MiFID II regulation was to bring more trading activity on exchange, but the combination of batch auction models, Systematic Internalizer registrations and industry innovations such as portfolio swaps and synthetic Prime Brokerage led to a higher level of internalization than before the rules were implemented.[2]

Question 8: Market participants: where available, please provide any data that illustrates the impact of broker preferencing on order execution for you or your clients (either positive or negative).

See Question 6 above.

Question 9: Please provide your thoughts regarding the view that broker preferencing conveys greater benefits to larger dealers.

Broker preferencing conveys benefits to smaller dealers as it provides greater public liquidity, price discovery and access to order flow than the US internalization model which excludes small dealers entirely. Broker preferencing is also superior to a pure price-time model which would favour US HFTs over smaller dealers.

The benefits of broker preferencing are mostly aligned to the ratio of active to passive flow for a dealer, not necessarily the size of the dealer. For example dealers with primarily active or primarily passive orders would be matched less frequently through broker preferencing than a dealer with a more balanced set of orders.

Question 10: Does broker preferencing impact (either positively or negatively) illiquid or thinly-traded equities differently than liquid equities?

We do not have direct data on the impact of broker preferencing on illiquid or thinly-traded securities, but we expect the frequency of broker preferenced trades would be lower on these securities as a function of their lower trading volume. We also expect the low liquidity of these securities would result in more instances where an entire level of an order book is cleared so the application of broker preferencing becomes irrelevant.

We do not see broker preferencing as being a key factor in the liquidity of thinly-traded equities. Liquidity is primarily a function of institutional ownership, retail interest, research coverage and global flows in the sector rather than market microstructure.

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[2] *Reuters Business News:Light or dark? Six months on, MiFID 2 rules divide equity traders. June 29, 2018*

Question 11: Do you believe that a dealer that internalizes orders on an automated and systematic basis should be captured under the definition of a marketplace in the Marketplace Rules? Why, or why not?

No we do not believe that dealers who internalize orders on an automated and systematic basis should be captured under the definition of a marketplace in the Marketplace Rules. Two primary functions of a dealer are to solicit contra-side interest for agency orders and to provide capital to clients as principal. Both of these roles require a relationship with the client and cannot be done anonymously on a public marketplace under a fair access model.

Historically these dealer roles were performed manually, but the advancement of technology has enabled greater speed and efficiency in agency order matching and client facilitation trading. We do not think the application of technology should change how an activity is classified from a regulatory point of view.

The CSA/IIROC consultation paper excludes the block trading "upstairs market" from consideration for policy changes. We do not see this market as independent from retail trading but part of a continuum. Some retail orders can be larger than institutional block trades and many small orders (retail or institutional) could be exposed to market impact if they did not have access to dealer capital.

The US upstairs market has rapidly evolved and innovated through the development of actionable IOIs and automated Central Risk Book execution for large size orders. Similar developments have been inhibited in Canada due to the application of "definition of a marketplace" in the Marketplace Rules. Policy changes should be considered to boost Canada's competitiveness in the upstairs market.

Question 12: Do you believe segmentation of orders is a concern? Why, or why not? Do your views differ between order segmentation that is achieved by a dealer internalizing its own orders and order segmentation that is facilitated by marketplaces?

We believe that some level of order segmentation is necessary to improve execution quality for certain classes of orders, but if taken to an extreme would harm market quality through excessive fragmentation. We have already seen examples of harmful marketplace innovations in Canada such as multiple medallions, make/take and take/make pricing and speed bumps.

The segmentation of retail orders in the US through wholesaling has been successful in improving immediacy, execution quality and market impact for retail clients. We have seen significant growth in US trading of Canadian equities through both primary US listings and OTC F-class symbols. This erosion of Canadian market share is a concern and is directly related to the inability to segment retail orders in the existing rule framework. Our mission as an industry should be to attract global flows to Canada by providing higher quality execution on Canadian securities than the US market.

Question 13: Do you believe that Canadian market structure and the existing rule framework provides for optimal execution outcomes for retail orders? Why or why not?

No, Canadian market structure is not optimal for retail orders. We see lower Price Improvement, higher Effective Over Quoted spreads and lower At Or Better percentages on retail orders in the Canadian market than equivalent retail orders in the US.

In terms of traded value, roughly 50% of the Canadian market is interlisted with US primary exchanges and this rises to close to 100% when including the US OTC market. Canada and the US function as a single North American market for equities, which places Canadian market share at risk if our market structure is not competitive with the US.

Question 14: Should the CSA and IIROC consider changes to the rule framework to address considerations related to orders from retail investors? If yes, please provide your views on the specific considerations that could be addressed and proposed solutions.

Yes, we believe the competitiveness of the Canadian market can be improved with a dedicated facility for providing liquidity to retail orders, open to all participants to interact with retail flow on a multilateral basis. This model would bring some of the advantages of the US wholesaling model through price improvement, reduced market impact and open competition for retail orders without the disadvantages of bilateral non-public arrangements. Small one-off institutional orders which have similar characteristics as retail flow could also be included in this facility.

We thank the CSA/IIROC for the opportunity to comment on the Consultation Paper and welcome any questions that either CSA or IIROC staff may have.

Respectfully,

<signed digitally>

David Panko
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TD Securities Inc.