By Email

May 31, 2019

To:

Investment Industry Regulatory Organization of Canada
British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumer Services Commission, New Brunswick
Superintendent of Securities, Government of Prince Edward Island
Nova Scotia Securities Commission
Office of the Superintendent of Securities, Service NL (Newfoundland and Labrador)
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon
Superintendent of Securities, Department of Justice, Government of Nunavut

Care of:

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Dear Sirs/Mesdames:

Re: Joint CSA/IIROC Consultation Paper 23 – 406, Internalization within the Canadian Equity Market

Thank you for the opportunity to comment on your internalization analysis.

As a general principle, internalization activities run contrary to the public interest. Invariably they involve some overt or covert scheme to strip a key element of the reward (price and time fulfillment prioritization) due a participant contributing to the price discovery process and to redirect same to the exclusive benefit of another, non-contributing participant. Allowing such activity erodes the incentive to contribute, thus undermining the collective interest.

Unlike their American counterparts, the Canadian securities regulators have, for the most part, recognized this fundamental principle and have therefore barred most internalization efforts. There have been a few notable exemptions: broker preferencing (which overrides time, but not price, priority) and pegging (typically embedded dark order functionality that is, at its core, parasitic to the price discovery process and which becomes outright insidious when mid-point applications are permitted). Historically, the former was a concession to the dominant brokers when the matching process became computerized. The evolution to multiple trading markets has substantially mitigated the negative impact of this exemption, as time priority is unrealistic across markets at the consolidated level. The latter remains a serious outstanding issue and the inconsistency of permitting trading inside the otherwise minimum trading increments for this specific type of activity is ironically providing an inducement for negative activity. This oversight should probably be addressed in keeping with the goal of promoting fair and efficient markets.

There has emerged, over the last year and a half, a communal consensus that various participants have possibly developed schemes to essentially replicate internalization outcomes while ostensibly staying within the letter of the law. Markets have been persuaded, for a capped monthly fee, to offer virtually unlimited unintentional crossing facilities for what are otherwise typically retail sized orders and participants have, allegedly, devised execution strategies that capitalize on recently introduced kinks in the order protection rules and/or that may also take advantage of latency differentials within their various order handling and execution systems in order to markedly increase their level of unintentional crosses. Other initiatives are not necessarily reliant on the "intentional" unintentional cross gambit. Some apparently rely on using broker preferencing, often on the less active marketplaces, to essentially capture all or much of their offsetting client flows. The specific mechanics will be left for those more capable to describe in detail. However, for our immediate purposes, this analysis will stay focused on the basic underlying principles.

Complementary to asking how, it is submitted that we should also perhaps focus on why. Schemes and strategies will constantly evolve to work within rules and prescriptive guidelines. It might prove more productive to understand how participants are incented to pursue such approaches so that we can understand their fundamental motivations and thus concern ourselves with addressing the core incentives encouraging such untoward activities.

In a nutshell: follow the money. Participants pursue internalization because it will benefit them at the expense of others. So, how big are these advantages and are there ways to reduce these incentives? The answers are, respectively, significant and yes.

At its core, internalization activities arise because we have a regulator mandated minimum trading increment (one cent per share for stocks trading above $1 and half a cent for those trading below $1). Participants have come to realize that, if they structure their processes accordingly, they can execute their clients' orders in compliance with their best execution obligations while retaining all, or a significant portion, of the mandated bid ask spread for themselves. It may seem inconsequential to be discussing something as small as a penny a share but, given the volumes being traded, there is a lot of money involved. Past analysis of just the Canadian markets has suggested that the regulator imposed minimum bid ask spread often results in investors forsaking as much as $100 million a month through reduced sales proceeds or inflated purchase prices. That is money that internalizing participants are incented to retain for their benefit.

To understand these calculations directly, take the total monthly trading volumes in Canada for shares priced above and below $1. Subtract all institutional blocks being crossed. Then assume that all trading occurred at the tightest bid ask spread permitted and multiply the remaining number of shares by the applicable minimum trading increment. Further assume that (70)% of all trades were in the naturally highly liquid securities typically trading at the minimum bid ask spread. In reality, many bid ask spreads will have actually been much wider because the inherent liquidity of the stocks in question, or the prevailing market risks in general, dictated that liquidity providers required a bigger inducement to provide the market support that benefitted investors. That would result in a greater collective monthly implicit cost, although the regulator mandated portion would not increase. That latter component will vary according to the percentage of trades consummated when the bid ask spread was at the minimum. Presumably IIROC and others will have that level of granular detail at hand and in short order more refined analysis will be available. Regardless, the main point here is that the amount of money available for internalizers is very significant.

The question then becomes: can we remove these incentives and what will be the impact? The immediate answer is fairly straightforward, we can either reduce or eliminate the minimum trading increment. Investors will be huge beneficiaries. However, some intermediaries will likely be less happy. A quick review of these specific dynamics might be in order.

Some dealers feel incented to find ways that they can still meet the obligation to provide best execution (here typically viewed as price) for their clients while, either directly or indirectly, causing their clients' order not to be exposed and thus not contributing as a public good to the open market. Instead, they would like to keep that information quiet, for the exclusive benefit of themselves and/or their associates. At its core, internalization is just a tool to extract the bid ask spread for the intermediaries, to the detriment of all other contributing participants. In some versions, the further irony is that they will use the tools of the dark market and the insidious pegging to facilitate stripping and utilizing the very informational public good that they are dishonouring in the process.

Generally, for the naturally very liquid securities (which usually collectively constitute a significant majority of the daily trading volumes in Canada), minimum trading increments create minimum bid ask spreads, which in turn translate into increased transition costs for investors. They are either receiving less for the sale and/or paying more for the purchase of the securities being traded. Ideally, investors would be best served if the bids and offers for any given stock were identical. There would be no implicit transition cost in the pricing. Historically, liquidity providers demanded wider spreads to compensate for the risks they assume when calling two sided markets. Over time, as volumes rose, investors demanded a reduction in the minimum spread and, over stages, regulators agreed. What was once a 25 cents spread is now a penny. As a rule, when spreads collapsed, liquidity increased and ultimately everyone won, although some may have taken time to realize or admit that.

The prevalence of mid-point pegging and inverted markets clearly tells us that, for many of the more inherently liquid securities, the current minimum trading increments are too wide. When liquidity providers are willing to pay maker fees on both sides of a trade in order to make the one cent spread, then we know that our regulatory model needs updating.

Liquidity providers adapt to market and pricing changes almost instantaneously and will continue to offer their services only if they stand to make a profit, net of all costs and risks. They have consistently proven resilient to change and so will likely just adapt and carry on. They will offer spreads (possibly none if the provision fees are sufficient) that reflect the risks of each security at the time in question. Dynamic market forces will provide the lowest possible transition costs to investors with no artificially imposed minimum spreads where none are otherwise required.

From experience we see that reduced spreads result in greater volumes and improved liquidity. Investors (both retail and institutional) will stand to gain accordingly.

The issue, as has often been the case, will be with the intermediaries. For stocks where the spread collapses entirely, inverted pricing will likely not be available. Dealers will thus no longer be able to receive payment for directing their clients' market orders to inverted markets in such instances. As they have not been under any requirements to forward such payments to their clients, it is reasonable to expect pushback from this stakeholder group. The obvious solution will be for them to adopt a practice of properly passing through the fees and rebates associated with fulfilling their clients' orders. This should possibly include all gains realized from internalization practices or processes. Such a requirement would likely result in all such initiatives being terminated as dealers would no longer have any upside to pursuing internalization strategies.

Investors will be ahead in this scenario as the gains from a reduced spread should outweigh the passed through costs, if any. In fairness to the dealer community, they might benefit from having such a cost and benefit flow through policy mandated by regulation. That way, all will have to comply and no one dealer will feel adversely prejudiced by otherwise being an early adopter of the more efficient pricing practices.

Perhaps this is all easier said than done, but it is the right direction and something that for some time many readers have known needs addressing.

These observations and comments are offered solely with the objective of making our markets as efficient, transparent and fair as possible. Hopefully that will in turn contribute to making Canada the global leader in market structure policies and regulations, as I believe we should be.

Thank you,

Ian Bandeen

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Co-founder and past Chair and CEO of CNSX Markets Inc, operator of the Canadian Securities Exchange
Co-founder and Chair Emeritus, National Angel Capital Organization