Via email: comments@osc.gov.on.ca; consultation-en-cours@lautorite.qc.ca; kmccoy@iiroc.ca

May 31, 2019

The Secretary
Ontario Securities Commission
20 Queen Street West, 22nd Floor, Box 55
Toronto, Ontario M5H 3S8

Me Anne-Marie Beaudoin, Corporate Secretary
Autorité des marchés financiers
800, Square Victoria, 22e étage, C.P. 246, tour de la Bourse
Montréal (Québec) H4Z 1G3

and

Kevin McCoy
Investment Industry Regulatory Organization of Canada
Suite 2000, 121 King Street West
Toronto, Ontario, M5H 3T9

Dear Sirs/Mesdames,

Re: CSA and IIROC Consultation Paper – Internalization within the Canadian Equity Market

This comment letter is being submitted on behalf of RBC Dominion Securities Inc., Capital Markets and Wealth Management ("RBC" or "we"). We are writing in response to the joint Canadian Securities Administrators ("CSA") and Investment Industry Regulatory Organization of Canada ("IIROC") Consultation Paper 23-406 - *Internalization within the Canadian Equity Market* published on March 12, 2019 (the "Proposal"). RBC appreciates the opportunity to comment on the Proposal; our comments are set out below.

One of the hallmarks of Canada's equity markets in recent years has been change. Similar to the United States, we view a significant portion of the Canadian evolution as being driven by the exchanges, for which innovation is often paired with or predicated on a profit seeking motivation that can have a negative impact on market quality. As a result, we have seen greater complexity and market inefficiencies in recent years, such as the introduction of randomized speed bumps and excessive rebates which can heighten broker order routing conflicts of interest and disrupt best execution. In our view, broker preferencing is a critical counterbalance to what we see as the exchanges' focus on ultra-low latency technologies and complex trading fees and rebates.

Broker preferencing is a unique and transparent feature of the Canadian marketplace. It benefits market quality by incentivizing market participants to post liquidity on lit venues, while improving the ability to capture the spread ahead of speed sensitive traders exploiting a technological advantage. We posit that a pure price/time priority order book may not be optimal for institutional and retail investors.

According to the Proposal, unintentional crosses have not grown materially over the last few years and represent less than 13% of total marketplace volume, a subset of which is a result of broker preferencing

(4.4% client-to-client and 2% client-to-inventory, as such percentages have been provided by venues that were able to offer data, as stated in the Proposal). Based on these percentages, we view time priority as continuing to be the dominate form of order matching on individual venues. While there may be areas for improvement, we do not see fundamental issues with nor substantive changes required to broker preferencing given the data does not demonstrate material marketplace issues.

Canada is a relatively illiquid market compared to its global peers – which makes it particularly difficult to trade passively. Brokers need tools to help their clients achieve best execution in an increasingly automated market. Broker preferencing is one such tool, that used the right way can improve execution quality in light of wider spreads and lower turnover common in Canada. For instance, corporate issuers conducting a normal course issuer bid have defined limitations imposed on their purchases and so benefit from broker preferencing as it improves their ability to trade passively.

We see a number of additional benefits that broker preferencing provides to the Canadian market, including:

- Incentivizing displayed liquidity which promotes price discovery;
- Improving the ability of retail and institutional investors to capture the spread through more effective passive trading;
- Increasing the likelihood of retail and institutional clients interacting with active retail flow, which is generally viewed as a favorable counterparty;
- Facilitating retail investors who benefit from interacting with other retail investors; and
- Helping to mitigate the segmentation driven by exchanges leveraging rebates to attract retail orders.

Potential consequences of limiting broker preferencing may include:

- Increasing focus by exchanges and dealers on maximizing their low latency offerings to the detriment of long-term investors;
- Increasing predatory market behavior, such as "fading quotes" which diminish the quality of liquidity within the market; and
- Decreasing quality execution opportunities for smaller dealers, who can leverage inverted venues to trade passively while benefitting rather high frequency traders to whom exchanges already cater.

Additionally, with less incentives for larger brokers to display liquidly, more liquidity will likely shift to dark venues similar to the United States. An increase in opacity could impact price discovery and require some dealers to develop more complex approaches to maintain execution quality.

As referenced in the Proposal, we agree there is potential for broker preferencing misuse, such as where brokers post within the order book in a systematic fashion with the advance knowledge of an incoming retail order. However, such behavior can be discouraged without significant revision to broker preferencing, such as by only allowing orders that have been resting for a minimum period of time to qualify for broker preferencing.

Excessive segmentation of order flow can lead to an unfair market, negatively impacting the common good. While internalization contributes to segregation, the current data set out in the Proposal does not reflect an excess. Also, exchanges like Alpha have used their ability to offer rebates and randomization to divert retail flow away from protected quotes. This can negatively impact the quality of execution for retail and institutional clients as noted in the CSTA Trading Issues Committee paper - *Discussion and position statement regarding: Speed segmentation on exchanges, Competing for slow flow*. We see broker preferencing as helping to balance exchange driven segmentation and provide an alternative to internalization.

The exchanges maintain a dominant position in the Canadian market structure with the ability to offer outsized rebates and low latency access to their largest market participants. Broker preferencing serves as a counterbalance and helps level the playing field for retail investors, which are vastly out represented by institutional investors. Limiting the tools a dealer has available at its disposal could negatively impact execution quality and create an imbalance that would not serve the marketplace common good.

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We appreciate the opportunity to provide comments and welcome the opportunity to discuss the foregoing with you in further detail. If you have any questions or require further information, please do not hesitate to contact the undersigned.

Thomas Gajer
Managing Director, RBC Dominion Securities Inc.

Cc:
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
Superintendent of Securities, Provincial Government of Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon
Superintendent of Securities, Department of Justice, Government of Nunavut