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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, Department of Service NL, Provincial Government of Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon
Superintendent of Securities, Department of Justice, Government of Nunavut

In care of

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<u>IIROC</u>
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Dear Sirs/Mesdames:

Re: Joint CSA/IIROC Consultation Paper 23-406 Internalization within the Canadian Equity Market (the Consultation Paper)

BMO Capital Markets would like to thank the Canadian Securities Administrators (the CSA) and the Investment Industry Regulatory Organization of Canada (IIROC) for this opportunity to comment on the Consultation Paper. We think this consultation raises important issues for the industry and how clients' interests are best served.

BMO supports the advantages accruing to investors through the availability of broker preferencing in Canada. We advocates for measures that reduce unnecessary trade intermediation in favor of internalization that results in reduced costs and better execution quality for client orders which at the same time serves to maintain market integrity, transparency, liquidity and fairness.

We think it is helpful to begin this comment letter by providing some historical data with respect to internalization rates in the Canadian equities market.

On the surface, internalization rates have been on the rise.

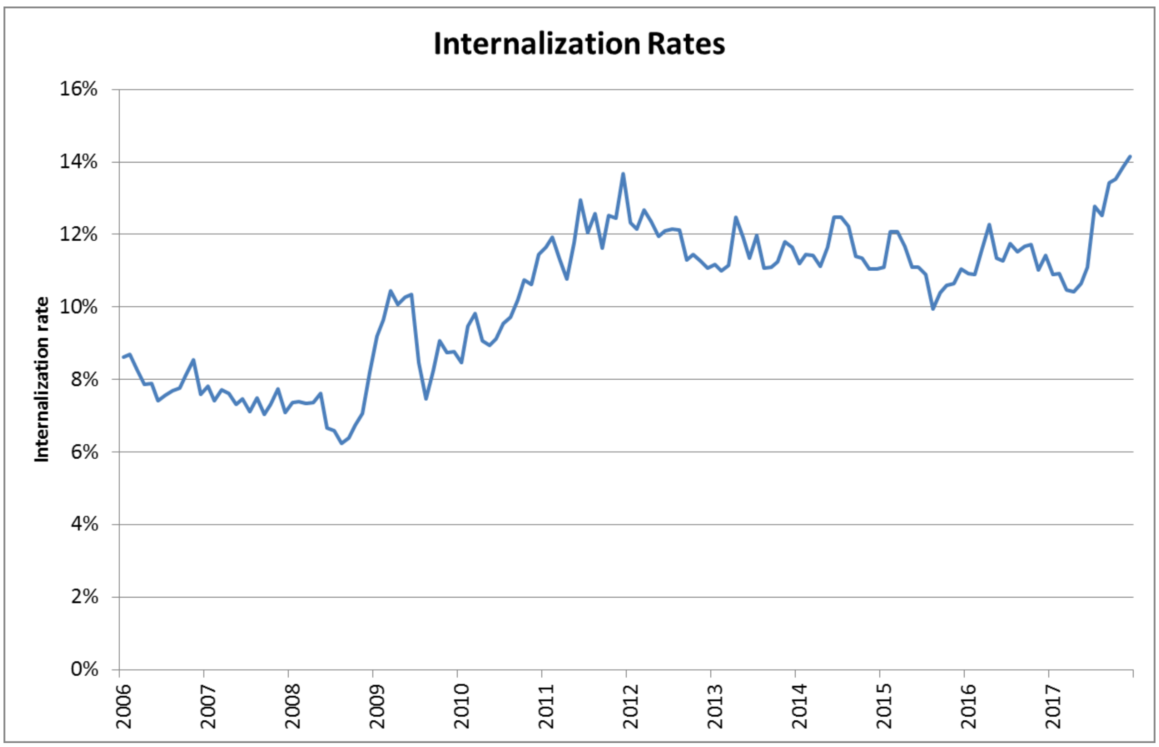
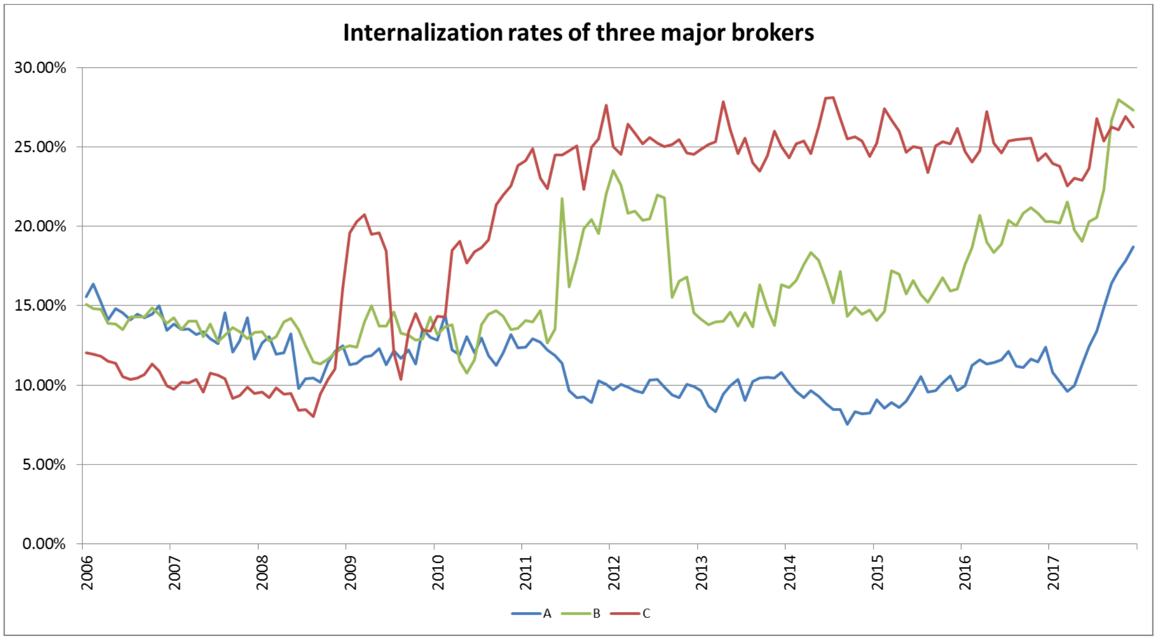
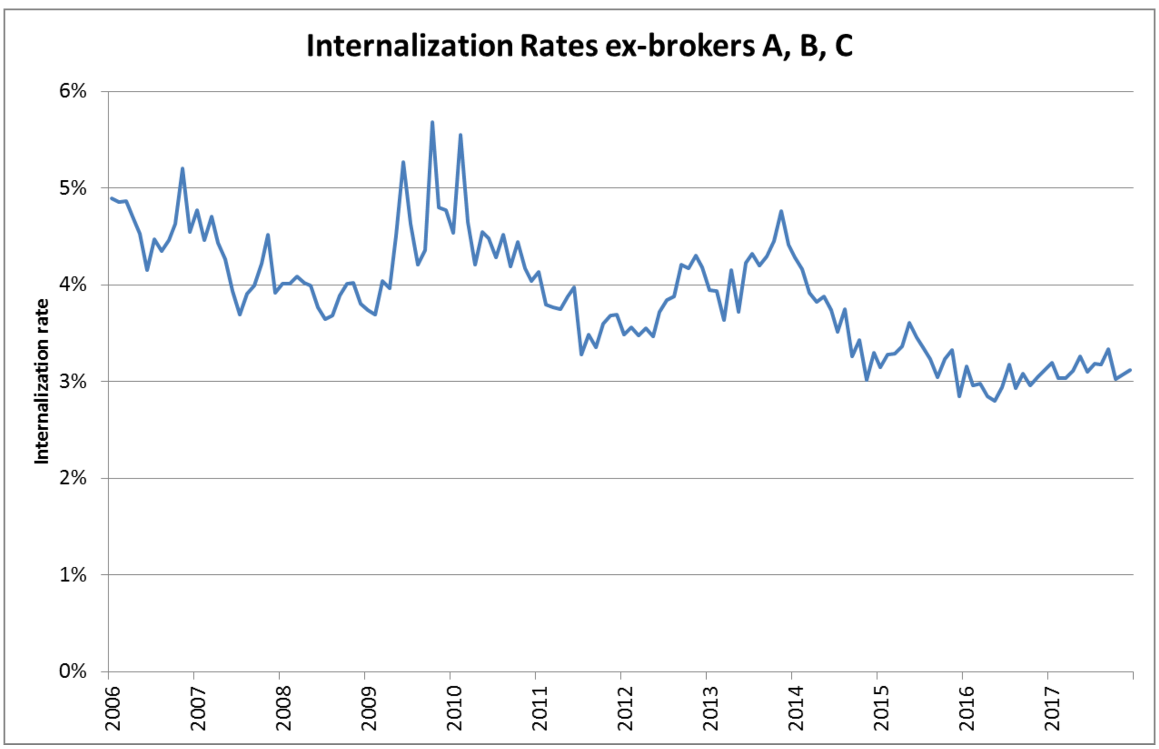


Fig. 1 - Internalization rate: same broker value traded / overall value traded
Excludes open/close auctions, upstairs block liquidity, ETF trades, and anonymous (broker 1) trades

However, when you look at the data a little closer, we can see that the activities of three brokers are the driving force behind the majority of the increase.



And that when the activities of these three dealers are removed, internalization rates have in fact declined by almost half in the Canadian equity market since 2006.



It is also important to be specific about the type of internalization that we believe is at issue. We support internalization that acts to bring together natural orders at the cross.[1] It is the "systematic

[1] References to "internalization" in this letter are to this type of internalization. We refer to "systematic internalization" where necessary to differentiate between the two phenomena.

internalization" of inventory orders by means of high frequency trading-like algorithms is not beneficial to the Canadian equities market.

Furthermore, we believe that any discussion on internalization should be connected to the rise in unnecessary intermediation. Recent history in the Canadian equity markets has seen an explosion of unnecessary intermediation. Marketplaces are incentivized to provide favourable rulebooks for intermediation, as this drives trading volumes which in turn drive revenue. Market makers themselves are motivated to engage in intermediation tactics as it helps them get a "first look" on the order flow. As internalization helps connect natural liquidity, intermediation acts to reduce the amount natural liquidity transacting against natural liquidity.

We agree with all of the Consultation's Paper's listed market attributes, although we believe that the CSA and IIROC should also be concerned with cost. Internalization reduces both explicit and implicit costs in the market. Increased unnecessary intermediation (the majority of which comes from the hand of high frequency traders) reduces of internalization rates, and forces passive natural orders to cross the spread in order to get a fill, increasing costs. Internalization saves market participants from the explicit costs associated with increased fees and commissions, as well as the implicit cost resulting from passive orders being forced to cross the spread.

Internalization through the optimization of routing is not a cost saving exercise for a dealer. This increases explicit trading costs for the dealer. The result though, for passive client orders, is better fill rates as intermediation decreases (and internalization increases). This further benefits market liquidity and transparency as the incentive increases for clients to book their orders "out loud".

Regulators have traditionally treated wholesale and retail markets differently when it comes to internalization, and we think this is appropriate. Within the wholesale market the upstairs matching of orders is a necessary requirement in order to ensure adequate liquidity and to reduce market dislocation. Retail (or small) orders are required to be treated differently in Canada. As a general rule, though there are exceptions which we discuss below, small orders must be displayed. Though we note that this is not the case globally. As the Consultation Paper itself points out, in the "United States, significant amounts of orders are traded by dealers "off-marketplace", and these orders are therefore never made available to the broader market". And what's true from the wholesale market is true for small orders as well.

Internalization in the Canadian equity market through on-market broker preferencing strikes the balance between the potential for small orders to get a better fill in the upstairs market and the need to provide transparency and price improvement to the marketplace as a whole.[2] It should not be the result that dealers, who have optimized their routing as a result of the increase in unnecessary intermediation, are the misplaced target of regulation that would result in permanently ceding the market to high frequency trading and the like. In this respect, internalization efforts of dealers (and their clients) are regaining their space in the market before the arrival of high frequency traders.

Moreover small orders also currently benefit from a number marketplace instruments that support best price execution. UMIR 6.4 and 8.1 mitigate the potential for client orders to be disadvantaged (and eliminate any conflict) by internally matching orders since the orders need to be immediately displayed or price improved. Best execution under NI 23-101 also removes the potential for brokers to route

[2] This argument is not as applicable to systematic internalization.

orders to one specific market in order to enhance the rates of internalization to the disadvantage their clients.

Canadian equity markets have become increasingly complicated, in large part due to a proliferation of order types and pricing models. These are almost singularly designed to increase market segmentation – to lure retail orders away from natural flow. In this sense, segmentation and intermediation are interchangeable. As marketplaces increase complexity, the result is smaller orders and increased intermediation, which results in higher implicit and explicit costs. It is our position that this has resulted in generally negative outcomes for the average investor. Order routing optimization is a chance for dealers, faced with a market that at every turn promotes segmentation and unnecessary intermediation, to look for better execution for their clients.

Finally, the Consultation Paper sets up the common good and individual good as mutually exclusive concepts; that the benefits accruing to some clients as a result of internalization necessarily detract from the overall common good. While we understand the Consultation Paper's interest in promoting the common good, this must still be balanced against the individual investors' interests. Indeed, such interest is enshrined in our market's best execution rules. Internalization connects willing natural orders on the board and thereby increases the efficiency of the markets. We suggest that this serves the original intent of marketplaces – bringing together natural buyers and sellers.

We would like to thank the CSA and IIROC for engaging the industry and for giving us the opportunity to provide feedback on this important topic. We would be happy to discuss any of the above with you by phone or e-mail. Thank you for your consideration.

Sincerely,

"*Dave Moore"*

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