May 31, 2019

VIA EMAIL

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

Dear Mesdames and Sirs:

Nasdaq CXC Limited ("Nasdaq Canada" or "we") welcomes the opportunity to provide comments on the Joint CSA/IIROC Consultation Paper 23-406 *Internalization within the Canadian Equity Market* ("Consultation Paper") seeking feedback in response to concerns regarding the internalization of retail orders within the Canadian equity market.

We believe there is a need to balance what helps investors maintain choice and allows them to lower costs with what is best for the market as a whole. As technology advances, participants are provided with new options to improve trading performance and lower costs. In order to ensure that a fair and efficient market is maintained and investors are protected, regulation needs to keep pace with innovation. Regulatory requirements that promote market integrity will vary across jurisdiction because of the need to recognize the unique characteristics of each market. With that in mind, internalization practices and the regulation that permits them must be understood in the context of the unique attributes of the Canadian equity market. In a market where a small number of large integrated dealers control the majority of the order flow, internalization practices must be considered in light of this significant concentration risk.

We believe that recent developments around internalization are not healthy and could negatively impact the market's long term condition. We therefore commend the CSA and IIROC on consulting with industry on these recent developments and recognizing the need to evaluate whether changes are necessary for the current rule framework to address concerns. The Consultation Paper shows a good understanding of the current situation. We applaud the CSA and IIROC for offering comprehensive coverage of the current internalization practices and asking the right questions in order to assess the need for regulatory change.

Nasdaq Canada's view of internalization is based on the following principles:

1. Internalization can benefit individual market participants while simultaneously harming the overall market; the costs and benefits must be balanced carefully.
2. Order interaction promotes price discovery and benefits investors; internalization and order isolation do the opposite.
3. With limited exceptions, price/time priority maximizes fairness.

Our responses to the important questions raised in the Consultation Paper are viewed through this lens.

Question: How do you define internalization?

Internalization should include any trade where the same dealer serves as both the buyer and the seller, whether intentionally or unintentionally. In the case of intentional internalization there is advanced knowledge of an order (either by a trader or trading system), and a decision made based on this knowledge to attempt to internalize by providing the other side of the trade. We believe that intentional internalization should be the main consideration under review whereby specific actions are taken by dealers to match orders before executing on exchange or by using the facilities and features of a marketplace. However, it is still important to track and measure unintentional internalization because marketplaces may offer features that provide benefits to dealers for unintentional crosses (through pricing, priority or other "creative" mechanisms) that create a conflict for dealers between prioritizing the potential opportunities to internalize to capture an incentive over best execution considerations.

Question: Are all marketplace attributes (liquidity, immediacy, transparency, price discovery, fairness and market integrity) relevant considerations from a regulatory perspective? If not please identify those which are not relevant and why.

All of the attributes are relevant considerations from a regulatory perspective. We note market stability, or the ability for a market to handle times of unusual volatility, should be understood as an important component of the investor confidence referred to in the attribute of Market Integrity. A market supported with risk management controls such as market wide or single stock circuit breakers will serve to support investor confidence more than a market without such risk management controls. Similarly, overall trading costs (explicit in the form of marketplace fees and implicit in the form of bid-ask spreads) are important when evaluating the liquidity and immediacy of a market and should be considered when assessing the

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efficiency of a market. Finally, a market's liquidity is supported by an ecosystem which provides for the interaction of order flow from all types of participants.

Question: 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.

Liquidity, and in turn immediacy, are potentially harmed by internalization when orders are matched away from the market before being executed on a marketplace because they would otherwise interact with orders on the book. Restricted access to private pools of order flow (on or off marketplace) not only impairs liquidity but can also raise fairness issues as investors may believe that certain advantages are enjoyed by certain participants and not others. Similarly, when order flow from one type of participant is removed from the market it negatively impacts liquidity by hurting the health of the market's ecosystem. Price discovery can be impacted because internalized trades deprive participants of useful pre trade information. Finally, excessive levels of internalization can also result in wider spreads and less efficient price discovery process.

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

In general, we believe that order interaction improves market quality for all investors; when order flow is restricted from interacting with other participants' orders, it negatively impacts the overall health of the market. The ecosystem of a healthy market functions best when order flow from different types of investors and participants are able to interact with one another. This interaction results in better quality market metrics including tighter spreads, robust market breadth and depth, effective price discovery and overall confidence benefiting all participants. With this in mind, excessive levels of internalization can be harmful to the market as a whole.

We recognize the benefits of lower execution costs (including trading and ticketing fees) and the resulting economies of scale that can be created for dealers (or their individual good) when able to actualize higher rates of internalization. However, these individual benefits must be evaluated against what is best for the market as a whole. Practices that discourage quote competition, restrict access to order flow and raise fairness concerns need to be scrutinized and overall internalization rates need to be monitored for negative impact to market quality. At some point the cost to the market from a high level of internalization will outweigh the benefits provided to individual dealers. Complicating things further, it may be difficult to identify when internalization practices have gone too far and, at that time, there may be limited options available to reverse its impact.

The Canadian competitive landscape is unique in that it is relatively small, and significant market power is controlled by only a few large integrated dealers. Unlike other markets where order flow is more widely dispersed, this concentration risk creates a real threat to the Canadian equity market. If order flow was permitted to trade off market spreads would widen, price discovery would suffer and overall trading costs would increase. This impact could extend to increasing the cost of capital for issuers and result in compromising Canada's ability to attract investments and capital formation. For this reason, developments

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in internalization practices need to be well understood and internalization levels need to be monitored closely.

Where internalization is permitted, any resulting benefits should be passed onto customers. Examples include when client orders are internalized with one another leading to less intermediation and when internalization facilitated by broker preferencing allows a dealer to unwind a position taken from using firm capital to facilitate a trade. The problem arises when technology is used to internalize retail orders with proprietary market making desks that may be able to use advanced knowledge of a retail order (unavailable to other participants) to internalize the trade. Should this happen, we believe that the individual good of the dealer is clearly being prioritized to the detriment of the common good.

We note that Figure 11 of Appendix A of the Consultation Paper shows an obvious increase in internalization rates between Client and Inventory and that this increase is evident for both unintentional and intentional crosses. These statistics are consistent with the recent efforts by certain participants to maximize internalization via both unintentional and intentional crossing mechanisms.

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

Strict price-time priority provides equal opportunity to all participants to compete for execution priority based on when an order is received, and in turn, exposed to risk. Philosophically then, we are opposed to broker preferencing because it provides a disincentive for those who are not customers of the preferenced dealer to provide liquidity which in turn adversely impacts quote competition and price discovery. However, we recognize broker preferencing is a viable alternative to internalization practices permitted in other jurisdictions including wholesaling of retail orders and where significant trading volumes are permitted by regulation to execute off exchange using the price discovery of public markets while not contributing to the pre-trade transparency used to reference trades.

Broker preferencing benefits larger dealers over smaller dealers by facilitating higher execution rates based on the number of orders handled instead of the time they are entered. It also serves to compound this advantage by creating an incentive for liquidity providers to become customers of large dealers and by creating a barrier to entry into Canada for foreign participants. However, large economies of scale that can lower costs such as those related to clearing and settlement, including post trade ticketing costs can also be passed onto clients.

Recognizing the advantages that broker preferencing affords large dealers, we also recognize that significant investment has been made by these dealers to develop their deep customer base, including a significant retail presence, and that the resulting economies of scale support the use of capital to facilitate client trades which is essential to the Canadian capital markets. We therefore are not concerned when broker preferencing is used to internalize client orders with one another or when it is used to unwind a position resulting from a liability trade. In our view the fairness issues raised by broker preferencing become a problem when preferencing is used to internalize client orders with proprietary desks and specifically when retail orders are systematically internalized with market making desks. Advances in trading technology systems have permitted market making desks to use broker preferencing to systematically increase the

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probability of internalizing a retail order with proprietary orders entered with the sole purpose to execute against the retail order with little or no chance of interacting with another participant.

Cross-seeking routing strategies also raise issues for best execution when the likelihood of internalization is prioritized over best execution considerations. By breaking up a single order and sending several smaller orders to multiple venues with the objective of maximizing internalization opportunities, the potential opportunity cost is introduced where the order that otherwise could be fully executed on a single market misses a trade after being broken down into multiple orders sent to multiple destinations. These strategies can also result in higher overall trading costs for clients if individual ticketing costs are passed on to clients. Illiquid venues that do not offer best execution metrics actually facilitate cross-seeking strategies because they decrease the likelihood of interference. This can distort best execution analysis by other participants when market share is overstated on smaller venues because of a disproportionate amount of volume traded attributed to cross-seeking strategies.

In the spirit of adding to the discussion there may be some options available to limit broker preferencing to its most noble purposes. We suggest the following alternatives for consideration:

a. Client Only

Regulation could require that only client orders are eligible for broker preferencing. This would ensure that the execution benefits of broker preferencing are provided to clients while the other benefits from internalization could still be retained by dealers. By disallowing an inventory order to be eligible for broker preferencing it would eliminate the incentive for dealers to use broker preferencing to trade against client orders however this would also make it harder for a firm to unwind a position taken from a liability trade. We recognize that there are some issues with using the client marker today that would make implementation difficult (such as the fact that DEA Client orders are marked client) but we believe that markers could be adapted to ensure retail and institutional orders are only afforded the benefit.

b. Minimum Resting Time Requirement

Broker preferencing could be available only for orders that meet a minimum resting time. This alternative would require an order to be exposed to meaningful risk and in turn contribute to liquidity before it is eligible to receive the benefit of broker preferencing. Adding this requirement would create challenges for dealers using strategies to systematically internalize retail orders because orders generated for the sole purpose of interacting with a retail order would not be able to avoid trading against orders from other participants as easily.

c. Illiquid Securities

Because broker preferencing may encourage liquidity provision on illiquid securities its use could be limited to securities with liquidity profiles below a certain threshold. We suggest IIROC explore the impact of broker preferencing on groups of securities with different liquidity profiles to better understand its contribution to liquidity and the liquidity profiles of securities where any benefit is seen.

d. Anonymous Orders Requiring Post Trade Attribution

Broker preferencing could apply only to anonymous orders while mandating that post trade attribution be required for trades resulting from broker preferencing. This option would eliminate

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the conflict created by cross-seeking strategies. Order attribution is generally accepted as the trade-off for receiving the benefits of broker preferencing because of the contribution made to pre-trade transparency. However, we question whether this is still a valid assumption. Most dealers seem very keen on using attribution to advertise their activity in a name, regardless of broker preferencing opportunities and without considering the risk of information leakage. By restricting broker preferencing to anonymous orders, information leakage would be minimized. These benefits would particularly be conveyed to smaller specialized dealers where it is easier to detect when a large sized institutional order is being traded.

We note that at least two marketplaces have been approved to allow broker preferencing on dark orders without requiring any form of attribution (pre or post trade). This form of broker preferencing promotes some intentional internalization practises that "fly under the radar" without requiring any contribution to transparency.

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

Both the positive and negative impacts of broker preferencing are accentuated for illiquid and thinly traded securities. On an illiquid security, broker preferencing may incentivize dealers to make markets thus contributing to liquidity where it is most needed. However, the cost of the fairness issues raised by broker preferencing is accentuated as orders with time priority from smaller dealers specializing in those securities are bypassed.

Question: Do you believe that a dealer that internalizes orders on an automated and systemic basis should be captured under the definition of a marketplace in the NI 21-101? Why or why not?

Yes, a dealer that internalizes orders on an automated and systemic basis should be considered a marketplace because this behavior creates the same concerns the marketplace definition is meant to address. Participants are effectively denied access to interact with this order flow which is effectively siphoned into a private pool and away from the market. In addition, the fair access requirements applicable to marketplaces regarding the use of indications of interest (IOIs), or when IOIs are considered to be displaying orders[1] should apply to a dealer trading system that is using information about orders (that are required to immediately be entered on a marketplace) to generate contra side orders before they are entered. When dealers that internalize orders on an automated and systemic basis are caught under the marketplace definition they should be required to provide information about these orders to all participants in order to meet the fair access requirements of National Instrument 21-101.

[1] Section 7 of CP 21-101.

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Question: **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 it is essential to ensure that a market supports an ecosystem where different types of order flow, each with its own trading objectives, strategies and time horizon, can interact. By restricting or constraining access or permitting discriminatory access standards across categories of participants the price discovery process is negatively impacted. True prices for securities are best established by all market participants and not a subset of them.

Recognizing the need to provide customers choice and to lower trading costs, we support tools that help achieve these objectives although they may result in a degree of customer segmentation when they attract more use by a segment of investors because they facilitate their trading objectives. For this reason we distinguish between explicit and implicit segmentation. We believe that marketplace features should be accessible by all participants on similar terms and conditions and customers should be free to choose how to use them. There is a difference between competing commercial models that incentivize participants to seek the services that best meet their trading needs and objectives (the by-product of healthy competition) and a trading platform that explicitly restricts access to a segment of participants. In addition, explicit segmentation results in the creation of liquidity silos that negatively impact market integrity and market quality.

We are opposed to features that explicitly segment order flow by restricting access to orders from certain participants. This being said we recognize that Nasdaq Canada has contributed to a form of this segmentation in the Guaranteed Execution Facility (GEF) that was introduced for competitive reasons. We note that although the GEF is only accessible to certain eligible accounts that this marketplace feature is nuanced as it is not provided in isolation. Market makers are required to meet obligations in order to maintain their market maker designation which contribute to market quality by way of better liquidity and market breadth.

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

Because of advancements in trading technology and the capabilities of participants we believe that additional guidance needs to be added to UMIR 6.3 - Exposure of Client Orders ("Order Exposure Rule," or "Rule") and that the exception from the Rule for "large" orders be revisited.

The Order Exposure Rule requires an order that does not exceed 50STUs to be immediately entered for display on a lit marketplace.[2] The time frame for "immediately" is not defined and, given advancements in technology what would be considered immediate today is very different than what would have been considered immediate only a few years ago. Because of innovation in trading systems, there is a possibility that a dealer or a dealer system can respond to an order before it is "immediately entered on a marketplace that displays orders." We understand the intention of the Order Exposure Rule at a minimum to mean that

[2] UMIR 6.3 Exposure of Client Orders.

"immediately" should not permit a trader or a trading system to react to an order it has received by entering an order on the market in advance based on this knowledge. In concept, this is similar to UMIR 4.1 – Front Running (UMIR 4.1) which provides certain prohibitions on trading when a participant has knowledge of a client order because of its role as an intermediary unavailable to other participants. Whereas UMIR 4.1 is concerned about trading in the same direction of the market that a client order may affect the price of,[3] in the context of internalization a dealer is using its knowledge of a client order to enter an order on the opposite side of the market. We believe that guidance needs to be included in UMIR 6.3 that will clarify that an order entered in response to knowledge about a client order that is required to be entered immediately on a market in accordance with the Order Exposure Rule is a violation of the Rule.

We also believe that the minimum size thresholds applicable to the Order Exposure Rule need to be revisited. Combining the 50 STU share requirement with the exemption for an order of $100,000 creates distortions in the application of the Rule. 50 STU on low priced securities is an easy threshold level for a retail order to exceed. Similarly, for high priced securities, an order for less than 50 STU can often meet the requirement to qualify for the $100,000 notional exception. In both cases retail orders are permitted to be withheld and allow time for a dealer to decide whether it wants to enter a contra-side order to internalize the trade. We recommend that IIROC perform an analysis similar to that which resulted in the proposed amendment to UMIR 6.6 where a notional requirement was added to the 50 STU for low priced securities.

Finally, we suggest that the CSA revisit its decision to not implement best execution reporting for dealers originally published in 2007. Similar to Rule 606 of Regulation NMS in the U.S. which require quarterly reporting from dealers about order handling and routing decisions, a Canadian requirements would provide clients with information to better understand how their orders are routed and in turn help them to evaluate the execution quality they are receiving. Disclosure of certain information can be mandated to become publicly available or can be provided upon customer request. Information about internalization rates and practices should be a requirement in this disclosure.

We thank the CSA and IIROC for the opportunity to provide comments and would welcome the opportunity to discuss further our views with staff.

Sincerely,

Nasdaq Canada

[3] UMIR 4.1 Frontrunning.

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