

**Canadian Securities Administrators/Investment Industry
Regulatory Organization of Canada
Joint Staff Notice 23-308**

**Update on Forum to Discuss CSA/IROC Joint Consultation Paper 23-404
“Dark Pools, Dark Orders and Other Developments in Market Structure in
Canada” and Next Steps**

I. Background

On October 2, 2009, the Canadian Securities Administrators (CSA) and the Investment Industry Regulatory Organization of Canada (IIROC and together with the CSA, we) published the CSA/IROC Joint Consultation Paper 23-404 *Dark Pools, Dark Orders, and Other Developments in Market Structure in Canada* (Consultation Paper), requesting comments on a number of market structure issues, particularly the impact of marketplaces that offer no pre-trade transparency (dark pools), the introduction of new non-transparent order types, and the introduction of smart order routers. We received 23 response letters from a range of respondents including marketplaces, buy side and sell side representatives, and industry associations. A summary of the comment letters received is included at Appendix A of this Notice and a list of commenters at Appendix B.

On March 23, 2010, the CSA and IIROC also hosted a forum to discuss the issues raised in the Consultation Paper and comment letters and to give respondents a chance to elaborate on their views. The morning session consisted of 11 formal presentations and the afternoon consisted of a roundtable discussion. Representatives from marketplaces, dealers and buy-side investors took part in the morning session and addressed questions from a panel consisting of senior executives from both the CSA and IIROC.¹ The afternoon session involved a roundtable discussion among the presenters facilitated by Wendy Rudd, which touched on issues raised in the Consultation Paper and in morning presentations. In addition, there was a luncheon keynote speech by Larry Tabb, founder and CEO of Tabb Group, discussing similar market structure issues in the United States.

Edited recordings of each of the presentations and the roundtable discussion² are available on the IIROC website at www.iiroc.ca under the heading “Member Resources” and the subheadings “Member Events – Webcasts/Recorded Events”.

¹ The panel consisted of: Louis Morisset, Superintendent, Securities Markets, Autorité des marchés financiers; Susan Wolburgh Jenah, President and CEO, IIROC; David Wilson, Chair of the Ontario Securities Commission; and Sinan Akdeniz, OSC Commissioner.

² The presentation and roundtable discussions were edited for the purposes of publication by removing housekeeping and other matters.

We thank those who contributed to the process by both responding to our request for comments or by presenting and participating in the forum. In particular, we thank Ms. Wendy Rudd who facilitated the afternoon session. We have gathered a great deal of information from this process and will be using it to inform our policy-making going forward.

II. Themes of the Forum

We identified a number of themes that emerged during the forum. Many reiterated issues that had been raised in response letters we received, while others went beyond the topics addressed in the Consultation Paper and touched on other market structure issues of interest.

Some of the themes directly related to the issues raised for discussion in the Consultation Paper included:

- the practice of broker preferencing³ at the marketplace level and internalization of order flow;
- the practice of dark pools sending Indications of Interest (IOIs) to attract order flow;
- the fairness of a marketplace using a proprietary smart order router (SOR) that has access to information on that marketplace that is not otherwise available to other marketplace participants;
- the use of market pegged orders⁴ and whether those orders “free-ride” off the visible market;
- whether dark pools should be required to offer price improvement; and
- the use of sub-penny pricing.

Issues related to the Canadian equity market structure that were not raised specifically in the Consultation Paper included:

- concerns about marketplace data fee increases with the emergence of multiple marketplaces;
- direct and sponsored access to marketplaces;
- the impact of high-frequency trading on the market; and
- the need for regulators to take a holistic view of the market when considering regulation instead of dealing with specific issues in isolation.

We have compiled a high-level overview of the views expressed both in writing and at the forum and also included below a discussion of ongoing initiatives and proposed next steps to address some of the issues.

³ We define broker preferencing to mean a marketplace feature that allows orders from the same participant or subscriber to execute ahead of other orders posted at the same price in a central limit order book.

⁴ Market pegged orders are orders which automatically and continuously re-price, according to changes in a reference bid or offer.

a. Broker Preferencing

There were many different views on this issue. Some participants supported the concept stating that in the absence of inter-market time priority that broker preferencing is essentially irrelevant. Others believed that broker preferencing is inherently unfair as earlier orders are bypassed and ignored. A common point of discussion was the concern that the removal of broker preferencing from the Canadian marketplaces might result in dark pools being established by dealers to internalize orders which would reduce transparency. Forum participants also indicated that due to the relatively small number of dealers that control a significant portion of the order flow, additional internalization of order flow at the dealers is a factor that should be considered when analyzing dark pools.

We acknowledge that broker preferencing is a unique feature of certain Canadian marketplaces and that it is a by-product of Rule 6.3 of the UMIR that requires dealers to immediately expose “small” orders on a transparent marketplace. This rule supports price discovery and increases the breadth and depth of the displayed market and provides direction to achieve best execution for these small orders. In other jurisdictions, these types of orders are often withheld from the market and matched internally by the dealer, therefore eliminating the need for broker preferencing. We agree that the impact of the internalization of order flow is an important consideration in our review of the issues raised at the forum, including broker preferencing.

CSA and IIROC staff intend to examine the issue of broker preferencing. We do believe that at the outset, more transparency is required so that market participants understand how all trading options offered by the marketplaces function. CSA staff are considering requiring that marketplaces provide specific disclosure on their websites on how orders entered on a marketplace interact with other orders on that marketplace throughout the day, including a detailed description of each order type. This proposal will be part of a package of amendments to National Instrument 21-101 *Marketplace Operation* (NI 21-101) and National Instrument 23-101 *Trading Rules* that will deal with updating the regulatory regime for alternative trading systems.⁵ CSA staff anticipate that the amendments will be published for comment by the Fall of 2010.

b. Dissemination of IOIs by Dark Pools

The main issues related to IOIs disseminated by dark pools in order to attract order flow were:

- the point at which an IOI becomes an order⁶ and becomes subject to the transparency requirements set out in Part 7 of NI 21-101; and

⁵ This project will be the second phase to related initiatives set out in OSC Staff Notice 21-703 *Transparency of the Operations of Stock Exchanges and Alternative Trading Systems*.

⁶ NI 21-101 defines an order as meaning a firm indication by a person or company, acting as either principal or agent, of a willingness to buy or sell a security.

- the fairness and transparency of marketplaces' practices with respect to IOI dissemination.

CSA and IIROC staff will be monitoring the initiatives taken in the U.S. with respect to "actionable IOIs".⁷ CSA staff believes that enhanced transparency of marketplaces' practices regarding the dissemination of information respecting orders and trades, including the provision of IOIs, will also address some of the concerns raised.

CSA staff are also considering providing clarification on the definition of an order and what features would qualify an IOI as an order.

c. Use of SORs by Marketplaces

This issue revolves around the concept of a marketplace-owned smart order router using information about hidden orders on that marketplace when making routing decisions. Although some felt that this practice was not a concern as this is a routing decision only, others thought that all visible orders at a given price should have priority over all hidden orders.

CSA staff are assessing whether the use of marketplace-owned SORs which take into account hidden liquidity available on their own book gives that marketplace an unfair advantage over other marketplaces and SORs. CSA staff are also considering the impact that this practice has on investors and will be examining whether marketplaces that provide information on hidden liquidity to their proprietary SORs should be required to provide the same information to other third-party SORs in order to meet the fair access provisions of NI 21-101.⁸

d. Market-Pegged Orders

Some forum participants raised concerns over market-pegged orders, specifically whether market-pegged orders have a negative impact on price discovery because they are simply free-riding the quotes from other marketplaces, and whether the unrestricted use of such orders created a disincentive to display liquidity. Others were of the view that many order types are variations of pegs, and that the concept was simply centralizing a process which could be, and is currently, done by dealer algorithms or manually, and thus would result in a reduction of message traffic between market participants. This was also consistent with the majority of the responses to the Consultation Paper, which did not raise concerns with pegged orders. We will continue to review proposed order types from marketplaces.

⁷ SEC Release No. 34-60997 (October 21, 2009). The SEC proposed that, if the practical context in which IOIs are transmitted renders them "actionable", for example if they include sufficient information (including symbol, side (buy or sell), size (minimum of a round lot of trading interest), and price (explicit or implicit)) they be included in the definition of "bid" or "offer" in Rule 600(b)(8) of Regulation NMS and thus become subject to transparency requirements.

⁸ Subsections 5.1(b) and 6.13(b) of NI 21-101 require exchanges and ATSS, respectively, to not unreasonably prohibit, condition or limit access by a person or company to services offered by them.

*e. Price Improvement and Sub-Penny Pricing*⁹

Forum participants discussed the idea of price improvement in dark pools, as well as the concept of sub-penny pricing. Questions were raised whether dark pools should always be required to offer price improvement, how much price improvement is meaningful, and whether sub-penny price improvement is desired or even relevant. It was noted that sub-penny price improvement may only be meaningful for dark pools achieving block sized execution, but is of questionable benefit to the overall market or to investors with small orders. Participants also discussed the fairness of allowing dark pools to offer sub-penny price improvement while transparent markets are not allowed to offer the same execution opportunities. Some participants felt that sub-penny quoting on visible exchanges would not be desirable, one reason being the impact of increased messaging due to sub-penny pricing on marketplaces' technology infrastructure costs.

We will examine the issue of sub-penny pricing with the goal of assessing how any changes in either printing or quoting in sub-pennies would impact both the market as a whole, and the individual participants. Additionally, we will consider both transparent and dark markets, and whether principles of fairness would allow both types of venues to offer sub-penny price improvement and printing or execution, or whether different market structure models necessitate different treatment.

f. Market Data Fees

Participants expressed concern that marketplace data fees are too high, especially in today's multiple marketplace environment where dealers need to consider data from all appropriate marketplaces, and not just those where a dealer is a participant. Some believed that dealers are, in effect, "captive consumers" of marketplaces' data, and that current fees for such data may not be commensurate with the marketplaces' market share or value of their data.

The CSA are currently conducting a review of all fees charged by marketplaces, including data fees. CSA staff's goal is to ensure that the costs involved with accessing services provided by marketplaces, including data, trading and routing are compliant with the fair access provisions in NI 21-101.¹⁰

⁹ Subsection 6.1(1) of the UMIR does not allow the entry of orders on a marketplace at a price that includes a fraction or a part of a cent, other than orders with prices of less than \$0.50 which may be entered to trade at an increment of one-half of one cent. However, executions for certain specialty orders (such as basis, call market or volume-weighted average price orders) may occur at sub-penny increments and may be reported in that fashion if permitted by the information processor or by the information vendor used by the marketplace.

¹⁰ NI 21-101 5.1 and 6.13 state that exchanges and ATSS must not unreasonably prohibit, condition, or limit access by a person or company to services offered by it. As indicated in Companion Policy 21-101CP, these includes services related to data.

g. Electronic Trading and Direct Market Access

Some participants indicated that the regulators should examine the issues surrounding direct market access.

In April 2007, the CSA and IIROC published proposals relating to direct market access. Since that time, the market has changed, technology has significantly advanced and regulatory regimes governing direct market access have changed in other jurisdictions. As a result, CSA and IIROC staff have embarked on a broad scope review of electronic trading in Canada, including direct market access practices, with a view to assess what requirements are needed to address credit risk, market risk and systemic risk to the Canadian market. The objectives of the review of electronic trading include assessing what controls, filters and other mechanisms marketplaces and market participants should have to prevent errors at the order-entry stage and, in general, to promote fair and orderly markets.

As a result of the market volatility experienced on May 6th, 2010, we have expanded the scope of the project to include the examination of other electronic trading issues, including the need to standardize the volatility parameters used by Canadian marketplaces in times of extreme volatility.¹¹

h. High Frequency Trading

It was suggested at the forum that regulators also review high frequency trading, particularly as its growth may have impacted time priority benefits and the ability of some market participants to achieve trade execution. We continue to monitor developments in this area, and particularly recent initiatives in the U.S. aimed at reviewing short-term trading strategies and their impact on the market. A review of issues associated with high frequency trading was also included in the scope of the project to examine electronic trading discussed above.

IIROC staff continue to monitor changes in patterns of trading on Canadian marketplaces, and the impact of “high frequency trading” is included in that monitoring. Changes in technology and the development of competitive multiple marketplaces have significantly increased message traffic and order to trade ratios. Future rates of growth in high frequency trading will be dependent upon decisions which may be made with respect to such issues as sub-penny pricing.

¹¹ Currently, some marketplaces use “freeze parameters” on their trading engines that allow them to freeze trading in specific securities where a significant price change occurs. This allows them to determine if a sudden price movement is due to potential erroneous trades. Currently, the use of these parameters is not consistent across the marketplaces.

i. Other

A few forum participants were concerned that the scope of the Consultation Paper and of the forum discussions was limited to issues related to dark pools and certain order types. They indicated that the CSA and IIROC should expand their review and take a holistic view of the markets rather than considering the issues separately.

We believe that we are accomplishing this through our review of the issues discussed above. These issues are not considered in isolation and are, in many cases, related. We believe that our approach also allows us to focus our consultation with market participants on specific issues and to elicit meaningful comments.

III. Conclusion

In the last few years, we have experienced significant developments in the Canadian capital markets. Most notably, the introduction of multiple marketplaces, which have different features and business models, has given rise to new market structure issues. We have described a number of initiatives currently in place to address such new issues. As we are working through these initiatives, we welcome any input and perspective of market participants. If you have any comments or questions, please contact any of the CSA or IIROC staff listed below.

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