



**Rethink
your stock
exchange.**

NEO EXCHANGE
neostockexchange.com

155 University Avenue, Suite 400
Toronto, Ontario M5H 3B7
T. 416.933.5900

BY EMAIL

May 16, 2019

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

c/o

The Secretary
Ontario Securities Commission
20 Queen Street West
22nd Floor
Toronto, Ontario M5H 3S8
Comments@osc.gov.on.ca

-and-

Me Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, rue du Square Victoria, 22e étage
C.P. 246, tour de la Bourse
Montréal (Québec) H4Z 1G3
Consultation-en-cours@lautorite.qc.ca

-and to-

IIROC
c/o
Kevin McCoy
Investment Industry Regulatory Organization of Canada
Suite 2000, 121 King Street West
Toronto, Ontario, M5H 3T9
kmccoy@iiroc.ca

Dear Mesdames and Sirs:

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

We appreciate the effort that went into summarizing what you consider as potential methods of internalization and the related statistics, as well as the background information that are reflected in the Consultation Paper. We also understand that the intention of this exercise was to present information, ask questions and not to come to any conclusions, but we are concerned that the length of time between the data collection and publication of the paper has made some of the statistics and, arguably, the focus of the paper less relevant.

In addition to the responses to the specific questions raised in the Consultation Paper, we would like to raise the following general points:

1. “Internalization” in its traditional form in Canada (crosses put together by dealers and reported to marketplaces as “intentional crosses”, i.e. the “upstairs market”) has been approached with caution due to its ability to negatively impact market integrity – primarily because internalized orders do not contribute to price discovery, free-riding on prices set by others and extracting liquidity from the market. On the other hand, it is also acknowledged that if orders of a substantial size are directly exposed to the market, this could lead to substantial price dislocation and resulting market integrity concerns. We believe that over time a fine balance had been struck. Any discussion about internalization should take these underlying market integrity principles into consideration.
2. Referencing unintentional crosses in the Consultation Paper as a form of internalization without any further context is unfortunate. For example, if investment advisors working in a dealer’s Victoria and St. John’s branches, respectively, happen to place orders that ultimately execute against each other without any assistance from their firm’s execution management system, it should not be considered to be internalization.
3. Similarly, considering broker preferencing as a form of internalization without any further context is, in our opinion, also unfortunate. The traditional way that broker preferencing has been enabled by transparent marketplaces does not have certain key attributes of internalization, as defined above, because the posted order contributes to price discovery and is available to be traded against by the orders of other dealers. On the other hand, when leveraging broker preferencing in a dark pool or with knowledge of an incoming liquidity taking order, the question of whether internalization is at play should be raised.
4. As a general principle, we believe that it is the expected outcome of leveraging an order handling method (enabled by a dealer, a marketplace or the combination of the two) that should govern, to determine if trades are to be defined as internalized or not. Further, existing and new

order handling methods should continually be assessed to confirm whether they are being used for achieving the outcome of internalization. We will discuss this further in our response to Question 1.

5. A number of concepts that may be associated with but are not necessarily “internalization” are also covered in the Consultation Paper, including retail segmentation (please see our response to Question 12). Given the recent trends and statistics collected, we believe that retail flow segmentation is the most pressing issue. We therefore suggest that the assessment following the Consultation Paper should focus on this issue, with the impact of dealers internalizing orders as a subset of that analysis.
6. The final, more general point we want to make relates to the fact that the data on broker preferencing does not include trades from all marketplaces because not all marketplaces are “able to accurately identify” such trades. This is a concern from several perspectives:
 - it is difficult to assess the materiality of that gap, as there is no disclosure about how much data is missing;
 - it is somewhat concerning that some marketplaces cannot properly identify broker preferenced trades – all marketplaces’ systems identify when an order’s broker ID trumps the time priority of other orders, and then execute upon that information; not being able to track those occurrences is concerning from the perspective of auditing and ensuring the proper functioning of a matching engine.

Responses to Specific Questions

Question 1: How do you define internalization?

As discussed above, we believe that, for regulatory purposes, the definition of internalization should be limited to the intentional use of methods – whether human or technology based – that ensure same dealer orders match with each other. The key is the high degree of certainty of the outcome: if steps are taken to enhance the likelihood of broker preferencing while respecting best execution and leaving the potential for matching with other dealers’ orders unchanged, it should not be considered internalization. Returning to some of the examples discussed above, we don’t believe that leveraging broker preferencing in a dark pool (or leveraging dark orders more generally) in itself constitutes internalization, but that leveraging broker preferencing by posting an order with knowledge of an incoming liquidity taking order is internalization. See also our answer to Question 11.

Question 2: Are all of these attributes [liquidity, immediacy, transparency, price discovery, fairness and market integrity] relevant considerations from a regulatory policy perspective? If not, please identify those which are not relevant, and why.

All remain relevant, in our view.

Question 3: 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.

Internalization can impact all of the attributes:

- it extracts liquidity from the market as a whole and this is particularly detrimental to smaller markets, such as Canada’s;

- internalization may be beneficial to immediacy if the dealer that is internalizing has a proprietary business to supplement client-to-client order internalization; and
- internalization negatively impacts transparency and, subsequently, price discovery, as the nature of “pre-arranged” trades is that they take place without other market participants being able to see quote adjustments and react, which is also detrimental to liquidity, fairness and market integrity.

We believe that growing levels of internalization in the Canadian market will lead to wider spreads and more unstable quotes, which are measurements of liquidity but also form the boundaries within which internalization takes place. Under these circumstances, quality of execution of internalized client orders, while still benefitting from immediacy, may be negatively impacted from a price perspective.

Question 4: Please provide your thoughts on the question of the common versus the individual good in the context of internalization and best execution.

As discussed in our response to Question 3, we believe that internalization, while being detrimental to the market in multiple ways, may be beneficial to clients of the dealers who have the capabilities and flows to leverage it.

This is, however, a limited part of the dealer community and would lead to further concentration of flows and an ever-decreasing number of dealers, which would negatively impact competition. There is also a risk that internalization will start to affect quoted spreads, which in turn may be expected to have detrimental consequences for all orders, including internalized client flow.

In other words, while in the shorter term there may be a conflict between the common and the individual good, we believe that with increasing levels of internalization the conflict will disappear and result in a negative impact on all dealers’ clients.

Ultimately the internalization debate is not that different from the debate around dark trading generally, and the same regulatory principles and considerations should apply.

Question 5: Please provide any data regarding market quality measures that have been impacted by internalization. Please include if there are quantifiable differences between liquid and illiquid equities.

N/A

Question 6: Market participants: please provide any data that illustrates the impacts to you or your clients resulting from your own efforts (or those of dealers that execute your orders) to internalize client orders (e.g. cost savings, improved execution quality) or the impacts to you or your clients resulting from internalization by other market participants (e.g. inferior execution quality/reduced fill rates).

N/A

Question 7: Please provide your views on the benefits and/or drawbacks of broker preferencing?

Broker preferencing is a longstanding feature of the Canadian markets that arose as a solution to deal with the concerns of dealers with a significant amount of client orders who were not able to: (a) allow their own clients that had placed limit orders to benefit from faster fills, nor (b) reduce their cost of trading. As a measure put in place to avoid a result where all the large dealers set up their own venues to achieve these objectives, it has generally been successful. In addition, all limit orders that may

benefit from broker preferencing are posted on marketplaces, contribute to price discovery (if on a transparent marketplace) and liquidity, and are accessible to other dealers; and, further, crosses in general reduce settlement risks.

The drawbacks are that the perception of fairness can be impacted if other orders do not get executed (or the immediacy of their execution is noticeably reduced).

Based on the partial set of data available for all marketplaces, and the specific set of publicly available data of our own trading books, current levels of broker preferencing do not seem out of range with historical patterns. Even if we assume that broker preferred trades represent 100% of unintentional crosses, we are looking at a maximum of 12-14% of the overall volume, value and trades, as of the first half of 2018. Given that the closest alternative to abolishing broker preferencing is to fully embrace the US model of dealer-run dark pools, including single-dealer platforms, this would on its face appear to answer the biggest questions about broker preferencing and provide an indication of the metrics that should be tracked at a high level for any red flags. Please see our further thoughts in our responses to Questions 9, 10 and 11.

It is concerning to us, however, when broker preferencing is used in a way that enables internalization as defined and discussed under Question 1, and note that the statistics provided do not allow us to understand the impact of these types of activities, nor their evolution over time.

In addition, we note that there has been some discussion about only allowing broker preferencing for client-client trades. We would like to highlight the fact that if such a step was taken, dealers with low latency DEA Clients would have a distinct competitive advantage over dealers with market making desks, which would also create fairness issues and, worse, further erode the ability of formal market making firms to commit reliable liquidity.

Question 8: Market participants: where available, please provide any data that illustrates the impact of broker preferencing on order execution for you or your clients (either positive or negative).

N/A

Question 9: Please provide your thoughts regarding the view that broker preferencing conveys greater benefits to larger dealers.

As noted above, dealers that have more two-sided flow and more client orders in general have more opportunities to benefit from broker preferencing. That said, given the low percentage of broker preferred trades – based on the available statistics – we find it hard to argue that there is evidence that suggests any material disproportionate benefits.

It would have been very useful to this analysis, though, to have access to better statistical information:

- providing a complete view across all marketplaces;
- splitting the data for traditional broker preferencing in transparent marketplaces versus broker preferencing in dark pools versus broker preferencing as part of a method to enable internalization as defined under Question 1; and
- splitting out the types of clients benefitting from broker preferencing, e.g., retail versus institutional and, if possible, low latency DEA Clients versus other clients.

Question 10: Does broker preferencing impact (either positively or negatively) illiquid or thinly-traded equities differently than liquid equities?

All things being equal, broker preferencing is more likely to impact perceptions of fairness in illiquid securities that already suffer from less-than-optimal liquidity. However, this result is balanced by the fact that it will attract liquidity provision by dealers active in those securities.

Question 11: Do you believe that a dealer that internalizes orders on an automated and systematic basis should be captured under the definition of a marketplace in the Marketplace Rules? Why, or why not?

Yes. This is a fundamental principle underpinning Canadian market structure. With large intermediaries and a small market (relative to other capital markets) and a significant amount of direct retail trading, the creation of silos would reduce efficiency and harm fairness. Most research on what makes a healthy market highlights transparency and a mixture of different types of order flows interacting with each other.

A consequence of being treated as a marketplace is that the fair access requirements apply. There is no reason why entities systemically matching multiple buyers and sellers should not be treated similarly. Alternatively, functionality or behaviours that achieve internalization, such as if a dealer automates and systematically leverages broker preferencing on marketplaces or if marketplaces adopt functionality that guarantees that a dealer only trades with itself, the rules relating to intentional crosses as defined in UMIR should be applied, as this activity is more similar to the traditional upstairs market where both sides of a trade are identified and then sent to a marketplace to be “printed”.

Again, it is important to distinguish between a dealer that simply optimizes its routing strategies to increase the likelihood for its active orders to hit or lift its passive orders first versus a dealer that uses the information about its marketable order flow to simultaneously place (and remove, if necessary) passive orders on marketplaces with the sole purpose of trading with its own orders.

Question 12: 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?

Segmentation of orders is a growing concern. There is a reason that professional traders seek to trade against retail orders – they are in general less informed and less price sensitive and rarely driven by fundamentals. They are also less directional. This creates more certainty for, and less price impact on, those that trade against them. This is the same reason why institutional clients prefer that their orders have the opportunity to trade against retail orders and why, ultimately, it would be better for retail to trade against retail without unnecessary intermediation.

On the basis of the assumption, as stated above and backed by research, that the healthiest markets have a good mix of different types of order flow, segmentation is an unhealthy trend, particularly in a market of the size of Canada’s, which already faces liquidity challenges.

Segmentation also is often associated with information leakage and all of this together is not good for buy-side institutions and anyone else who is not in a position take advantage of the functionality that creates the segmentation.

We have commented recently¹ that by enhancing segmentation through marketplace functionality (functionality that makes trading unappealing to buy-side and proprietary traders) and adding pricing incentives, one particular marketplace is seeking to replicate the US wholesaling model and create a mechanism for facilitating payment to retail dealers for their order flow. If this outcome was achieved directly, between dealers, it would violate UMIR. The method used for order segmentation, similar to the method used for internalization, should not matter; only the result achieved. In the example about the marketplace discussed above, the form is unimportant, as the impact of the activities – whether at the marketplace or dealer level – is the same whether it is achieved through functionality, fees or any other feature.

Question 13: Do you believe that Canadian market structure and the existing rule framework provides for optimal execution outcomes for retail orders? Why or why not?

The existing rule framework ensures that dealers must, for “small” orders, either provide the best publicly available price or improve upon it. In general, retail orders are small enough to be filled without a significant amount of effort to source the liquidity and there are a number of different market models to allow dealers to optimize their quality of execution.

The key aspects to provide support for optimal execution outcomes for retail orders that we believe are missing are set out below.

- The absence of meaningful validation tools to address the potential conflicts of interest associated with the payment of rebates by marketplaces, such as standardized reporting on routing strategies and quality of execution, similar to that in the US. In the absence of the widespread availability of such information it is left to regulators to attempt to prove that routing to the marketplace that pays the highest rebate is detrimental to quality of execution, which is in most cases difficult, if not impossible.
- The fact that the vast majority of retail investors and investment advisors do not see consolidated market data (as contrasted with the US, where it is mandated); this provides them with a poor view into the activity in the markets, the amount of liquidity available, and how orders are executed, which leads to uninformed investment decisions, uninformed trading strategies and ultimately being excluded from the markets if there is a TMX outage, such as that experienced in 2018:
 - in the case of TSX-listed ETFs, for instance, they are seeing less than 50% of the orders and trades, which we understand, anecdotally, has caused a number of occurrences of investors walking away from an investment, based purely on an incorrect assessment of the liquidity or because the last sale price on TSX is stale (and no longer a true reflection of the fund NAV), and more accurately-priced trades have taken place on other marketplaces not visible to the investor;
 - relying solely on the operation of the order protection rule will not lead to optimal execution when a retail client might have chosen to put in a limit order rather than a marketable order based on a full view of market activity in a particular security, and received a better price.

¹ https://www.osc.gov.on.ca/documents/en/Marketplaces/com_20190411_neo.pdf

Question 14: Should the CSA and IIROC consider changes to the rule framework to address considerations related to orders from retail investors? If yes, please provide your views on the specific considerations that could be addressed and proposed solutions.

As discussed above, we are not in favour of internalization as we defined it under Question 1 beyond traditional upstairs market crosses that are printed on marketplaces and subject to order exposure and price improvement requirements under UMIR. We believe that all the more recent practices using technology to enable internalization without being caught by the regulatory framework for intentional crosses should be banned as they do not benefit the market overall and in that way ultimately harm retail investors.

As suggested in our response to Question 13, we believe that changes should be considered to require the provision of access to consolidated data real time data for retail investors and investment advisors. We are aware that this has been viewed as a choice by each dealer, but it is a choice driven purely by necessity (as costs today would be prohibitive) and investors are not aware they are not seeing all the data. It would be unfair to add requirements imposing significant costs beyond those currently charged, which leaves two potential solutions: the CSA could treat fees for non-professional displayed data similarly to the process for professional data and set maximum fees for each marketplace based on an aggregate benchmark amount (i.e. it could be limited to what is currently paid for only TMX data) and some combination of share of volume, value and trades, or could require dealers to meaningfully analyze their indicative data and include this analysis in their best execution policies and procedures.

We believe that there should be mandatory reporting by dealers with respect to routing strategies and quality of execution. This should be available publicly in aggregate for retail investors as well as privately for institutional investors in a format that allows them to compare dealers on an apples-to-apples basis.

Finally, we support the proposed IIROC changes to the dark rules, which assist in better protecting retail orders in lower priced securities and the CSA's trading fee pilot.

Question 15: Are there other relevant areas that should be considered in the scope of our review?

There are a number of other areas that we believe should be considered in the review:

- *Market Making Programs*

All exchanges in Canada except NEO offer versions of a “guaranteed minimum fill” facility as part of their market making programs. We are supportive of providing benefits to market makers as long as they are balanced against the obligations imposed on them, and as long as the benefits do not promote segmentation. Although we published a proposal for such a facility several years ago, we ultimately did not implement it as we felt and continue to feel that these types of facilities do not pass that test. There are no meaningful obligations that the market makers must fulfill, and the benefit is that they get to interact with retail flow only. We also question how these type of facilities are in compliance with the current dark rules when small retail orders are getting filled without price improvement by market makers who have not placed any visible orders.

- *Proliferation of Order Types*

As mentioned in our previous comment letter on the TSX “SDL Plus” order type², whenever a marketplace proposes functionality that replaces one or more functions typically performed by

² https://www.osc.gov.on.ca/documents/en/Marketplaces/com_20190411_neo.pdf

a dealer (as was the case with the two order types discussed in that comment letter), the proposal should be put through the following lens: would that functionality be allowed if performed by a dealer? In the same spirit, we believe it would be appropriate to review all available order types in the equity markets to determine whether or not they are aimed at or contribute to segmentation.

- Trading Fees

One of the biggest contributors to segmentation is the current bifurcated market structure with maker-taker and taker-maker (inverted) pricing. That is one of the reasons we are supporters of the proposed trading fee pilot and hope that the Canadian regulators will move forward with non-interlisted securities despite the uncertainty in the US around the proposed SEC pilot. In the absence of that step, we would urge the CSA to implement a similar type of fee cap for inverted markets as that which exists for make-take markets, or we will see a continued escalation of inverted fees as marketplaces continue to fight for the highest rebate. Other than to facilitate retail segmentation, it makes no sense that the fee to post on an inverted market can be higher than what is acceptable as a take fee on a make-take market. Although we appreciate that the intention behind the fee cap on active flow is to protect the flow that is “forced” to access a protected quote, another prisoner’s dilemma appears to have been neglected. Dealers posting their institutional flow on inverted markets to shorten their time to trade have to cover that cost with commissions. There is a point where posting fees for institutional dealers exceed commission rates, leaving only proprietary firms willing to pay to post to trade with retail flow. Recent proposals in this area are those from TSX Alpha and Nasdaq CX2 to introduce separate (and more beneficial) fees for retail flow. This is even more concerning and is enabling indirect wholesaling of order flow in Canada, despite the prohibition against payment for order flow among dealers.

We believe that Canadian market structure is evolving in an unhealthy direction. It is critical that regulators re-confirm the core regulatory objectives, in consultation with all relevant stakeholders, and then take a clear stance in supporting those objectives.

Thank you for your consideration.

Yours truly,

“Cindy Petlock”

Chief Legal Officer
Neo Exchange Inc.

cc: marketregulation@osc.gov.on.ca
Jos Schmitt, CEO, Neo Exchange
Joacim Wiklander, COO, Neo Exchange