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BY EMAIL

Market Regulation Branch
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- AND -

Ms Randee Pavalow
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Dear Mesdames/Sirs:

Alpha ATS LP ("Alpha") Proposed Changes to add the IntraSpread Facility

We appreciate this opportunity provided as a result of OSC Staff Notice 21-703 – *Transparency of the Operations of Stock Exchanges and Alternative Trading Systems* to comment on Alpha's proposed IntraSpread facility and new Dark and Seek Dark Liquidity (SDL) order types. In our constantly evolving markets, it is important to ensure that as many views as possible are elicited on new trading types and orders to help maintain market integrity and investor protection principles.

Background and process issues

CNSX Markets Inc. operates both Pure Trading and the CNSX listed market. Both are "lit" trading venues. Our position, consistent with our responses to a number of CSA market structure initiatives over the years, is that healthy markets require a sufficient amount of transparency and must be perceived to be fair, and to achieve the latter there must be investor confidence in the price discovery function. This means that any deviation from transparency should be preceded by a full review of its costs and benefits. We have also stated that we are supportive of dark pools for trading large blocks, as they provide benefits not only to those placing the order, but also the markets generally, by avoiding undue market impact.

With a few limited exceptions, the practice of internalization and the use of dark order types each by their nature reduce the amount of liquidity sent to the public books. However, historically there have been forms of dark trading allowed, to achieve certain perceived benefits. The IntraSpread facility, as currently outlined, is a combination of these features.

We have heard arguments that the IntraSpread proposal should go forward on the basis that it fits within precedents established by previously accepted products and is simply maintaining the status quo while the CSA/IIROC project on dark trading is concluded. We dispute that this is the case, but even if so, this particular initiative significantly changes the risk profile since it is not being offered by a new entrant with barriers to entry, but by an entity with enormous economic clout and the potential to rapidly expand the amount of dark trading in Canada. For these reasons alone the IntraSpread facility should not be implemented without a clear regulatory policy position on key issues such as whether there should be limits on dark trading, and a clear vision of how the health of the pricing mechanism will be monitored. Adding to our discomfort is the fact that Alpha management has indicated that the currently proposed functionality represents the first stage of a broader internalization mechanism.

The argument that Alpha's IntraSpread facility should proceed at this point based on precedents is, in our view, an oversimplification of the issues. Existing order types/pools were set in an environment with minimal multi-market experience and limited public and industry input and can be distinguished in various ways, such as the fact that one was based on the entity being a call market, and that others provide open access to the dark orders or have a size threshold. *We cannot stress enough how important it is that the principles, and not just the precedents, are carefully considered, because once in place, it is very difficult for regulators to reverse an approved or accepted product or service*.

Alpha has stated that the benefits of its proposal are to reduce costs to its dealer subscribers and provide non-transparent trading with price improvement. We believe there are three important, inter-related issues to consider: 1) the impact of increased internalization; 2) what constitutes meaningful price improvement; 3) minimum order entry and trading increments.

Internalization

The direct benefit of internalization (used here to mean intentional order matching within a single firm, however it is accomplished) is lower trading and clearing costs to the internalizer. We do not dispute that a widespread cost reduction for all dealers would be a benefit to the industry; however, whether these cost savings are ultimately passed on to clients would be up to each dealer. Further, the value of enhanced internalization capability is highly dependent on the amount of order flow that can be matched internally, making it of most benefit to the large firms.

Question 1: Has any data been collected on the estimated cost savings to dealers of different sizes, to help assess the scope of the potential benefit and to determine if some dealers would receive disproportionate benefits?

Ironically, the first dark pools developed in Canada were aimed at a "democratization" of block trading by providing alternatives to the upstairs market. Alpha is proposing to create Upstairs Market version 2.0, a low cost method, without the risks or costs related to displacement rules, and without full tick price improvement. We need only look south of the border to see where the combination of the heavy use of internalization and order wholesaling, and not-insignificant use of dark pools can lead. Although there are many views on the cause of the "flash crash", it seems clear that a lack of diversity in liquidity caused by the shifting of tradeable non-professional orders from the transparent markets into internalization facilities and dark pools was a major contributing factor to the suddenness and severity of the market event in the U.S.

Question 2: Have any volume estimates been calculated, based on the proposed functionality and the current business models of Alpha members, and has any further consideration been given to imposing caps on trading in dark facilities?

Broker preferencing, a trading system-enforced method of seeking out crosses for orders from participating dealers, is already available on Alpha and several of Alpha's competitors, including Pure Trading. It does not, of course, create the same savings in trading costs as full internalization, but it maintains pre-trade transparency of the resting order and does not rely on free-riding on the prices set by others.

It is our submission that, in an environment where most transparent marketplaces already provide an internalization function in their trading algorithms, the benefit of a marketplace offering a full internalization facility is incremental. This partial benefit should be balanced against the fact that there may be unintended consequences from going further with marketplace-facilitated internalization. Fundamentally, systemic fully-internalized trading does not appear to be consistent with the spirit of the Universal Market Integrity Rules (UMIR) order handling and best price requirements or the CSA's order protection rule.

Question 3: Is it technically possible, under this model, for a client's Dark order and a dealer's proprietary SDL order to match, resulting in the client providing the dealer with price improvement?

Price Improvement

The second stated benefit of the IntraSpread facility is price improvement to clients. This is not simply a benefit, however, but also a UMIR-required element in order to allow Alpha (or any other marketplace) to offer trading without pre-trade transparency of all orders, regardless of size. For the reasons set out below, we believe that it is time to revisit the application of the price improvement rules.

UMIR include requirements aimed at ensuring that a critical mass of trades are carried out on visible marketplaces (e.g., order exposure, customer/principal and off-marketplace trading rules), but they allow a number of exceptions based on price improvement. At the time when most, if not all, of these rules were created, the minimum tick was 1/8th of a dollar; being obligated to price improve was a significant constraint. With penny spreads now maintained on many of the most liquid stocks in Canada, and the ability to meet the price improvement obligation with less than the minimum tick, the disincentive for systemic internalization imposed by the price improvement requirement has been substantially reduced at best. We submit that the original approach in the price improvement rules, that the improvement be "meaningful", was correct, i.e. that client orders should be exposed to the public markets unless the internalizing dealer is prepared to offer price improvement equal to the minimum tick in force for the security.

We are aware that there are order types based on sub-tick price improvement currently in use, including those offered on Alpha, but these were established before the transparency initiative of the OSC, making it even more important that all the issues are dealt with before moving to the next level of dark trading. Looked at from another perspective: is the price improvement offered by internalizers of sufficient value to each investor that the benefit balances the harm caused to the public markets from the withdrawal of these orders from the price discovery mechanism?

Question 4: If marketplace-facilitated best execution through between-the-spread price improvements is a main driver behind this initiative, has any consideration been given to why existing methods such as MatchNow or Alpha's Inside Match order have not been more widely used?

Sub-penny trading increments

We have for some time seen issues around the use of sub-penny trading increments in the trading process. There are clearly appropriate uses: VWAP trades and basis trades are examples where the price of a trade is derived from a number of factors that may not round out to the appropriate UMIR tick. We are concerned, however, with the unintended consequences of permitting dark markets to "quote" (as opposed to "print") in increments inside the UMIR-specified tick.

Enabling one market mechanism to accept bids and offers, and provide execution services, inside the minimum tick appears to create a competitive imbalance in the provision of marketplace services. In our view, offering this advantage to dark pools, in the event that the Alpha proposal is allowed to proceed, only increases the likelihood of harm to the price discovery process vital to the proper functioning of the markets. We submit that to level the playing field, if they handle the same orders and sizes, then all marketplaces, whether dark or lit, should be treated equally, including being given the ability to accept orders and report trades in sub-penny increments. Otherwise, an unfair advantage would be granted, incenting a practice that undermines price discovery.

Question 5: Are the regulators prepared to immediately reduce the minimum order entry increment in UMIR 6.1 to allow the visible marketplaces to compete on a level playing field?

Additional questions

In addition to the issues discussed above, we have some other questions in relation to the Alpha proposal:

6. Why do trades in IntraSpread not set the last sale price?
7. How does the exclusion of access to a Dark order entered in the IntraSpread facility to all but one subscriber meet fair access requirements?
8. Alpha is not proposing to offer inter-dealer preferencing at this point. Will subscribers be able to accomplish this by offering jitney access instead?

In conclusion, we repeat our concerns that a service that has the potential to facilitate the systemic internalization of a significant percentage of the order flow that would otherwise be entered onto the Canadian public markets should be carefully reviewed, and the impacts understood, prior to any implementation.

We hope that our comments will contribute to your deliberations and would be happy to discuss any of the above points.

Yours truly,

C. Petlock

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