January 26, 2011

Market Regulation Branch
Ontario Securities Commission
Suite 1903, Box 55
20 Queen Street West
Toronto, ON M5H 3S8

Randee Pavalow
Head of Operations and Legal
Alpha ATS LP
70 York Street, Suite 1501
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Attention: OSC Staff and Ms. Pavalow

Re: Alpha ATS LP Notice of Proposed Changes to Alpha IntraSpread Facility ("Notice", "Revised Facility")

Chi-X Canada ATS Limited ("Chi-X Canada" or "we") appreciates the opportunity to comment on *Alpha ATS LP's Notice of Proposed Changes to Alpha IntraSpread Facility*. Although we recognize changes have been made to the original proposal, we believe that the Revised Facility continues to raise similar concerns about restricting interaction of order flow within one dealer. In our opinion, the Revised Facility offers unfair advantages to certain participants by restricting the use of "Seeking Dark Liquidity" Orders (SDL) to retail investors and effectively limiting Dark Orders (DO) to non-retail investors. We believe these restrictions, in addition to creating an unlevel playing field, will negatively impact price discovery and overall liquidity in the market.

The objective of the Revised Facility, as stated in the Notice, is "to provide choice and options to accommodate different trading strategies and market participants." As the first marketplace in Canada to offer smart order routing, trade-through protection and the prevention of locked and crossed markets, we strongly believe that innovation engendered by competition results in improved efficiencies and greater trading options for all market participants. Although we have been public proponents of innovation and have empowered our customers with choice, we believe that the benefits offered through innovation should be enjoyed by all market participants and not be restricted to serve the interests of a limited few.

As a general principle, we believe that all investors should be afforded the opportunity to interact with all available liquidity. Although the Revised Facility does not include an internalization order (which restricts interaction of orders within a single dealer), we see this model as effectively producing the same outcome. By restricting Seeking Dark Liquidity (SDL) orders to retail investors and employing a price/broker/smart size/round robin execution priority methodology, dealers that support large retail businesses are effectively able to interact exclusively with their own retail flow regardless of other liquidity in the marker.

RESTRICTED ACCESS TO ACTIVE FLOWS IN THE REVISED FACILITY

Passive retail orders – Although retail orders are permitted to be entered as Dark Orders in the Revised Facility, their use will be limited because of the order exposure rule. As a result, non-retail participants (proprietary orders and institutional orders) will effectively be afforded the exclusive ability to access SDL active retail orders. Not only does this disadvantage retail investors from interacting with these orders, but it will also lead to adverse selection. Whereas the majority of active retail orders are entered as single orders, many active non-retail orders are part of larger parent orders that can move the market. As a result, when a retail limit order is executed outside the facility, there is a higher likelihood that the market will move against them. We believe that any market model that discriminates against retail investors should not be permitted in order to protect these investors.

Investors who are not customers of banks with large retail businesses – Canada's retail market is controlled by a few large dealers. Because of broker-preferencing within the Revised Facility, a trading participant who is not a customer of one of these dealers is effectively restricted from interacting with its retail flow. Whereas broker-preferencing offers the privilege of a "first look" to customers at the same price level on a lit book, the Revised Facility effectively offers the "only look." While we feel broker preferencing on lit books produces numerous harmful effects, orders at least follow time priority within the preferenced firm, and are eventually exposed to orders from all types of participants. By contrast, passive orders entered in the Revised Facility are exposed only to retail orders and preference is given to large sized orders over those posted first. Whereas any order posted on a lit market is exposed to the full range of contra-side orders, from small to large, a large sized passive order can be entered into the Revised Facility to gain allocation priority with the expectation of being exposed to only smaller size active retail orders and therefore little risk of being fully executed. This combination of size priority and broker-preferencing interacting only with retail flow creates the Canadian equivalent of the wholesale facilities in the United States that are currently being scrutinized by regulators. In the Revised Facility, how can any participant other than a broker with a robust retail business access this flow?

RESTRICTED ACCESS TO PASSIVE LIQUIDITY IN THE REVISED FACILITY

Any dealer that does not support a retail business is unable to take advantage of price improvement opportunities within IntraSpread. This raises issues regarding best execution for dealers executing institutional client orders. How are these dealers able to fulfill their best execution obligation if they are not able to access the best prices available? Best execution is defined in UMIR 5.1 as "diligently pursuing the most advantageous execution terms reasonably available under the circumstances." We question any facility that restricts certain participants from price improvement opportunities that are unavailable to others.

As outlined in our response to Alpha's first IntraSpread Facility proposal, the creation of any two-tier market results in:

- Undermining investor confidence by creating unfair advantages for some participants over others;
- Violating the principle of fair access by restricting liquidity to only certain participants;
- Further market fragmentation by creating isolated pools of liquidity;
- Hurting price competition by disadvantaging and therefore discouraging price setters, resulting in wider spreads and increased overall trading costs.

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Recognizing the risk that the Revised Facility poses to the Canadian market, let's evaluate what benefits it purports to offer. The Notice outlines the following objectives:

1. To enable retail flow to participate on the active side and receive a guaranteed price improvement, a larger fill, and a lower active fee;

We do not see how retail flow is restricted in participating on the active side today, or, given that most retail orders are small in size, the need for size discovery beyond that offered by the NBBO. With regard to price improvement, we question the meaningfulness that the Facility will offer. Algorithms trading larger orders usually attempt to use mid point orders to decrease market impact and for size discovery opportunities. Given that the active orders in the Revised Facility are limited to retail sized orders, size discovery possibilities will not be likely for passive orders. Instead, the model is structured to comply with UMIR 8.1 CPT by providing insignificant price improvement while maximizing spread capture opportunities for dealers. This true objective is apparent by the model capping the 10% price improvement order offset option (one of only two available) at a penny. If the real intention of the Revised Facility is to provide price improvement for retail customers, why limit this potential? Finally, it is not possible to assess the realization of the purported benefit of reduced fees. There is limited transparency into what fees are passed on to retail customers and even if a lower active fee were paid per trade, there is no assurance any savings would be passed on.

2. To enable buy side clients to post Dark Orders and benefit from accessing the active flows

As noted above, buy side clients can currently take advantage of the benefits of minimized market impact by using dark orders on lit marketplaces that support them. The ability to access the Revised Facility's active flow is predicated on becoming a client of a dealer with a large retail business. This raises anticompetitive concerns for dealers in the market who do not service a large retail customer base because the decision of which dealer to use will be driven not by performance, pricing and service, but rather on the robustness of the dealer's retail business.

This asymmetry will serve to further consolidate business with the large Canadian banks that already enjoy dominant positions reinforced by broker-preferencing. The Proposed Facility combined with broker preferencing creates a ring fence around large pockets of liquidity concentrated within these few firms.

3. Enabling liquidity providers to post Dark Orders to benefit from access to active flow

This objective can be achieved without creating unfair advantages for certain participants over others. Any dark facility or lit marketplace that supports dark order types that do not place restrictions on which participants can use dark orders would allow the benefit of accessing active flow to be enjoyed by everyone.

CSA/IIROC Position Paper 23-405 outlines the regulatory process when reviewing a marketplace's rules proposal, "we (the CSA and IIROC) review the proposed market structure and order types if they pose market integrity concerns, support a fair and efficient market and foster investor confidence."[1] Given that the Revised Facility's model raises market integrity concerns by unfairly advantaging certain participants over others (including retail investors) it is hard to imagine how it can be viewed as fostering investor confidence. With the benefits of the facility being limited to dealers with large retail businesses, we question if this type of innovation causes more damage than good.

[1] Joint CSA/IIROC – Position Paper 23-405 – Dark Liquidity in the Canadian Market.

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We thank you for the opportunity to comment and would be pleased to discuss our comments with you further upon request.

Sincerely,

Chi-X Canada

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