



INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

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October 25, 2011

Dear Sir/Madam:

Re: Provisions Respecting Dark Liquidity

Thank you for providing us the opportunity to comment on the proposed amendments to the UMIRs (the “Proposed Amendments”) relating to dark liquidity on Canadian equity marketplaces.

General Comments

In general, the IIAC supports the efforts of the CSA and IIROC (the “Regulators”) to understand and identify possible issues in the nascent area of dark, or undisplayed liquidity. We are, however, concerned that in developing the Proposed Amendments, efforts to put dark and lit liquidity on equal regulatory footing have failed to take into account the key differences in how these markets serve investors, and the way in which they operate.

We agree that as a general principle, it is appropriate to design a regulatory structure that will encourage the posting of orders on marketplaces’ visible order books and expose as much liquidity as possible to the widest variety of market participants. Such

regulation, however, must provide flexibility to allow for situations where posting on lit markets does not serve the clients' best interests and may ultimately prejudice the entire market by reducing the total amount of available displayed and undisplayed liquidity.

It is extremely important to recognize the differences in why and how investors access dark liquidity when developing a regulatory structure. Dark liquidity provides market participants with specific features that allow them to serve clients in a way that is not possible on a lit market, by potentially reducing market impact, information leakage, and facilitating trading strategies that maximize the benefits of both dark and lit liquidity.

It is critical that regulation is developed in a manner that will advance the objective of transparency, while retaining the best execution advantages afforded by dark liquidity. A one size fits all approach to regulation will significantly reduce dealers' ability to offer critical trading strategies to clients using undisplayed liquidity. This result does not advance investor protection, and may reduce participation in the market in general in light of these features which are available in alternative markets to those in Canada such as the US.

In developing the regulatory solutions and restrictions on undisplayed liquidity, the advantages of the protected market status granted to lit markets must be considered. Dealers are not compelled to subscribe to dark markets, and in most cases, must access the liquidity on lit markets first. Given the regulatory advantage of operating a lit market, the business models providing dark liquidity options differ in that they must earn their subscription base, and are not subsidized by guaranteed access fees and market data fees. As such, dark liquidity providers must offer investors ways to achieve best execution that are not available through protected marketplaces.

We are of the view that certain provisions of the Proposed Amendments will diminish the utility of dark markets and orders, and reduce the advantages to clients of having access to this valuable source of liquidity. This does not advance investor protection, and may in certain cases drive up costs without providing additional investor protection or any other commensurate benefits to the market in general or to individual clients.

Specific Concerns with the Proposed Amendments

Better Price Requirement

The better price requirement is an example of regulation that does not take into account the differences in the regulation and business models of dark and lit liquidity providers.

As noted above, the existing regulation encourages transparency by granting lit markets "protected marketplace" status. This, along with the Order Protection Rule ensures that all visible and displayed portions of orders at the same price on a particular marketplace have been executed first.

We believe it is appropriate to permit dark orders to execute at the NBBO provided that orders interact with lit orders at the NBBO first. The priority of lit orders and the minimum size requirement would encourage transparency, and allowing execution at the NBBO for the remainder of the orders would not prejudice the market in general or the client.

In addition, the better price requirement does not take into account the access and trading fees charged by the lit market. If price improvement is required, these fees should be taken into consideration in ascertaining better price. The hidden costs associated with the lit market, including the make or take pricing structure, drive up the cost of trading for smaller retail orders, which is counter to the intent of the regulation. These costs would provide a disincentive to post dark orders that may interact with those on the lit market, resulting in wider spreads and reduced liquidity in general.

It should be noted there is no price improvement requirement in the US, which has much more long standing and highly developed dark liquidity markets.

Prior to imposing a better price rule, it is important to have empirical evidence to demonstrate that the visible market would be somehow hindered without such a requirement.

Matching Priority of Lit before Dark

We agree that lit orders should have priority over dark orders at the same price. The Proposed Amendments would ensure that all displayed orders were given priority over the hidden portion of iceberg orders, which in turn were given priority over fully hidden orders on the same venue. We support this prioritization.

We are, however, concerned that the matching priority requirement may provide a business advantage to lit venues that provide dark liquidity that compete against dark markets that are not protected markets. Specifically, dark markets cannot leverage both a dark and lit book by offering both in the same protected marketplace. In order to retain the advantages of dark liquidity, separation of the dark venues from lit venue matching engines should be considered.

Minimum Size Requirement

We reiterate the concern expressed in our previous submissions with imposing a minimum size requirement on dark orders. Although no specific threshold is set in the Proposed Amendments, we do not believe that creating a provision is necessary. As stated in the notice, UMIR Rule 6.3, the Order Exposure Rule already results in a minimum size rule for dark orders.

There are a number of legitimate business reasons for smaller orders to utilize dark liquidity providers. We are concerned that a minimum size restriction for undisplayed orders would prevent dealers from optimizing their ability to seek out liquidity, and therefore impede their ability to achieve best execution. The price improvement and market impact benefits that are offered by trading using dark liquidity would be substantially decreased under the Proposed Amendments.

We are also concerned that the Proposed Amendments do not allow small passive dark orders that are part of an order placement strategy for a larger parent order. This restriction does not take into account the increasing fragmentation in our markets and the manner in which sophisticated algorithms and smart order routers break up large orders to achieve best execution for clients. The Proposed Amendments may have the effect of forcing order flow, other than large trades, to the lit markets, where they expose their intentions for all to evaluate and potentially trade against. This means that the long

term investors posting passive limit orders will be forced to compete with high frequency traders on the lit markets. Ultimately this will not only reduce smaller orders, but larger orders as well, as larger orders may remain in the dark market where they will not provide liquidity except in the case of a large contra order.

This may ultimately reduce the order flow on lit markets, limiting the options available to traders attempting to obtain best execution while buying or selling a large position. Since the strategies often are to break larger orders into smaller pieces, and trade some portion on the visible market, this may result in having a larger number of such orders being held back entirely in the upstairs market.

IIROC Questions

In respect of the two questions posed in the Notice, members of the IIAC Working Group did not express a position as they were not viewed as particularly relevant in light of the Proposed Amendments.

Conclusion

Although we support the regulatory objective of encouraging market transparency, regulators must recognize that investors' needs are not homogeneous. Where possible, the market environment should include tools that serve a wide variety of interests provided that the general integrity of the market is preserved. Dark liquidity provides an important and viable alternative for both retail and institutional clients to access institutional liquidity, lower market impact costs, minimize information leakage and trading strategies, and achieve better price and lower execution costs.

We would be pleased to discuss these concepts with you at your convenience. Thank you for considering our comments.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'S. Copland', written in a cursive style.

Susan Copland