Scotia Capital Inc.
Global Equity
Scotia Plaza
40 King Street West, 68th Floor
Toronto, ON M5H 1H1

GLOBAL BANKING AND MARKETS

Scotiabank

May 31, 2019

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

and

Me Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, tour de la Bourse
Montréal, QC, H4Z 1G3
consultation-en-cours@lautorite.qc.ca

and

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

Via Email

Re: Joint CSA/IIROC Consultation Paper 23-406 – Internalization within the Canadian Equity Market

Scotia Capital Inc. appreciates the opportunity to comment on the Joint CSA/IIROC Consultation Paper on the topic of equity order flow internalization. We believe the topic under discussion is central to the functioning of healthy Canadian equity markets. We will respond to most but not all questions posed within the Consultation Paper. Our response should be considered in its entirety, as our responses to some questions will have applicability to other questions.

Question 1: How do you define internalization?

The practice of dealers matching their various sources of flow with each other before exposing those sources of flow to the broader market

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Question 2: Are all of these attributes relevant considerations from a regulatory policy perspective? If not, please identify those which are not relevant, and why.

Yes. We believe all these attributes are relevant considerations for the purpose of setting regulatory policy.

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.

We view the effects of internalization on the listed attributes as follows:

Liquidity:

In situations where order flow is internalized among pre-existing client orders with no incremental facilitation capital, the liquidity characteristics of the market *as a whole* are the same whether orders are internalized or otherwise. However, there is an externality which must be considered: orders outside of the dealer internalizing are not able to participate in the trading activity, and from the perspective of those orders, the market becomes less liquid.

In situations where order flow is internalized through facilitation activities of the dealer, the introduction of dealer risk adds to the overall liquidity of the market. However, this incremental addition of liquidity is only available to the order flow being internalized. Participants operating outside the dealer at question will continue to see the market as becoming "less liquid" as they are not able to interact with either the originating (internalized) order or the dealer's risk capital. We therefore believe that liquidity provided to the open market is more valuable to the health of the overall market than liquidity provided through internalization activities.

Immediacy:

For active, liquidity-seeking orders which can be satisfied from resting orders in the market, the practice of internalization does not generally improve immediacy. These orders are indifferent to which counterparties they trade with; a fill in the open, multilateral market is as good as a fill from an internalization mechanism.

The issue of immediacy is frequently conflated with size improvement offered by some internalizers or by retail wholesaling firms. We acknowledge that size and immediacy are linked. However, we believe that the size improvement being made available to internalized orders (in excess of size available in the open market) as "provision of liquidity" rather than an improvement in the immediacy of execution.

We also believe that internalization techniques may improve immediacy for resting orders, as optimization in routing to improve internalization rates among natural flows should result in resting orders being filled faster than through time priority in the marketplace. Additionally,

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internalization techniques may overcome some of the fragmentation-related issues with competing queues across multiple marketplaces, benefitting the resting order. We highlight, however, that this benefit accrues only to orders within the dealer – and as a result the outcome for other orders in the market may be commensurately negative.

Transparency:

The objectives of transparency are generally compatible with internalization practices in an attributed environment. However, we believe that current practices of unattributed (anonymous) broker preferencing on certain marketplaces compromise the transparency objectives of Canada's regulatory framework.

Price Discovery, Fairness and Market Integrity:

We believe that the price discovery mechanism in the market is predicated on maximizing the diversity of participants willing to express their views on security value through visible orders in the marketplace. Other marketplace functions – equity underwriting, block facilitation, non-displayed trading – are reliant on a sufficient diversity of participants and views to ensure that market prices accurately reflect all available information.

The practice of internalization risks compromising this mechanism by imposing an externality on the participants whose order flow is not being internalized. Those participants will face greater difficulties in execution and have weaker incentives to rest orders in the marketplace. Additionally, the removal of natural flow from the multilateral market mechanism can be expected to increase the overall level of toxicity (risk of adverse selection) in the marketplace. In turn, this reduces the incentive for participants to rest visible limit orders in the marketplace and hence promote price discovery.

Additionally, an increase in order flow toxicity would fuel the perception that the market grants unfair advantages to the larger dealers, those with the scale to internalize effectively, to the detriment of smaller and less-sophisticated participants. Perceptions of such harm could be a risk to market integrity, whether warranted or otherwise.

We do not believe this is a purely hypothetical fear: the publication of certain literature related to high frequency trading led to widespread perception that the U.S. market is "rigged" – whether the facts support that argument or otherwise. We believe that it should be a policy objective for Canadian regulation to avoid such perceptions in the future.

Other attributes:

We believe the common thread in the attributes identified above is the breadth and diversity of participants in the open, multi-lateral marketplace. A greater number of independent risk-seeking participants will improve price discovery, add to liquidity, and promote perceptions of fairness in the open market.

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In the context of internalization, the fundamental objective should be to preserve and foster a wide diversity of participation in the open market. If all dealer flow is internalized, then the individual participants whose flow comprises any one dealer's activity are reduced to a single "dealer" source – and diversity is reduced. Therefore, a key consideration in any policy discussion of internalization should be ensuring that a wide mix of types of participants are involved in the open market, including a range of participant sizes, investment objectives, time horizons, trading strategies and intermediary functions.

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

We believe the practice of internalization is, fundamentally, an attempt to achieve individual good (either for the dealer or the client) at the expense of the common good.

Consistently with our response above, the practice of internalization imposes an externality on the participants whose flow is not receiving the benefit of greater immediacy of execution or greater incremental risk capital. The opportunity cost to those participants (missed fills, or ultimately worse execution prices) is the cost to the "common good" resulting from this practice, which must be balanced against individual benefit. .

There are several dimension to the "individual good" being sought by dealers who engage in internalization:

- Maximizing interaction among clients leads to being able to charge commissions on both sides of each trade.
- The market risk (directional or otherwise) from being on the other side of client flow may be seen as ultimately profitable.
- Interacting with other participants in the market (i.e. paying take fees or resting on inverted venues) is expensive. As a result, interacting with retail flow at an overall facilitation loss may still be cheaper than executing it outright.

These are all fundamentally economic factors. Internalization is seen as supportive of either higher revenues or lower costs for the parties internalizing order flow. We do not believe this is necessarily a problem in itself: a profit motive is fundamental to capital markets. However, in the context of the "common good" we believe the regulatory question is one of balancing the profit motive of dealers and market-making firms with the overall integrity and quality of the marketplace.

We believe that dealers which handle both sides of any given trade are deserving of the benefits of bringing those buyers and sellers together. By forcing the interaction between these parties to occur on a marketplace, or (worse) forcing those parties to trade with someone other than each other, costs are imposed on both the clients and the dealer. In other words, direct interaction

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among clients of the same dealer is a beneficial outcome. A dealer which can accomplish this should not be penalized through the imposition of additional frictional costs.

The dominant issue of "individual good" is the internalization of retail order flow. This source of activity consists of many diverse participants whose order flow is considered "non-toxic" due to the independence of each investor's decision making from any other investors' decisions. By internalizing this flow, dealers stand to reduce execution costs, increase revenue, or both. In this situation dealers may not be able to maximize client-to-client interaction, but rather would be facilitating retail activity through the use of risk capital. This practice stands to remove an important source of participation in the open market and hence harm the "common good."

We believe that it is important to strike a balance between these factors. Historically, the Canadian market has achieved this balance by mandating that orders at or below a defined threshold (50 board lots and less than $100,000 in value) be immediately exposed to the market. This ensures that many small orders from many independently-acting retail customers are reflected in the open market and supports the "common good." On the other hand, Canadian regulations require all participants to attempt to do their best for their clients, either as dealers offering "best execution" or as investment managers acting on their fiduciary duties by seeking best execution in the market. The result is that each participant is individually motivated to do what's right for them without necessarily being concerned with the "common good."

Notwithstanding the best execution mandate, there are additional measures which (appropriately) place the common good ahead of the individual good. One key example of this is the Order Protection Rule, which prohibits trade-through with the stated policy objective of preserving market integrity and perceptions of fairness. While a particular participant may choose to "trade through" for the purpose of immediacy or considerations of trade size, the common good argument prevents smaller orders from being bypassed. We note, further, that the Order Protection Rule also imposes direct costs on dealers, as protected orders include those on the marketplaces which are most expensive for dealers to interact on. As a result, dealers support the common good through their cost structure.

On balance, however, the strong requirement to seek individual "best execution" is at odds with a marketplace which preserves the "common good." Best execution and fiduciary obligations prompt both investors and dealers to act in a manner which is self-interested. For example, if the common good is served through practices which result in greater information leakage, this will likely be deemed unacceptable for institutional fiduciaries whose duty, first and foremost, is to their investors. Similarly, dealer active routing practices which result in identical fills but which result in a lower fill rates to natural resting orders in the market may be economically desired by the dealer and meet their best execution obligations, but nonetheless not be in the "common good."

If the conclusion is reached that some rebalancing of incentives and participant actions is required, we believe it would be beneficial to also concurrently clarify what is meant by "best execution" in the context of the common good.

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

We view broker preferencing as a "compromise" which attempts to balance dealers' incentive to match orders within their channel against the "common good" imperative of representing orders in the open market.

We believe that broker preferencing is an appropriate trade-off in the context of other key components of the Canadian market framework:

- Attribution of orders to the executing dealer.
- The requirement under the Order Exposure Rule to expose small orders to the public markets.
- The generally concentrated nature of participation in the Canadian market

While broker preferencing itself is a reasonable approach to achieving the trade-off between price discovery and the ability of dealers to match their orders together, it bears noting that the benefits of broker preferencing have greatly eroded in a multiple marketplace environment. Order flow fragmentation in the most liquid stocks has resulted in matching quotes across multiple markets, all of which now offer broker priority for fills. As a result, it is not enough for dealers to simply route to "the market" in the knowledge that their resting orders will be able to take advantage of broker priority for a faster fill. Instead, to benefit from broker preferencing dealers are now required to also optimize the specific marketplaces on which they attempt to benefit from broker priority. These "advanced" routing approaches still cannot result in the same benefits of broker preferencing that existed in the past, when the trading environment was more concentrated among a small number of marketplaces.

If one goal of the broker preferencing is to prevent dealers from creating systems designed to optimize intra-dealer order flow interaction, then this goal is inhibited by the fragmented nature of trading. Dealers with multiple independent source of flow are unable to rely on broker preferencing alone, and will therefore seek more direct means of promoting client-to-client interaction.

Additionally, we believe the "spirit" of the broker preferencing compromise lies in allowing pre-existing long-lived orders an opportunity to receive fill priority for interacting within a particular dealer. The modern practice of using short-lived orders to achieve the effect of broker preferencing appears to be at odds with the intent of the mechanism. The use of broker preferencing in this manner presents questions around fairness, and whether a short-lived order is truly "exposed" to the market.

More generally, some participants have expressed the concern that broker preferencing is currently being used to achieve indirectly (through workflows) an outcome which could be done directly.

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We would prefer that rather than relying on indirect workflows, means to achieve the same result without the use of broker preferencing should be sought.

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

We believe that broker preferencing provides the greatest benefit to those dealers which have a significant amount of active order flow. This does not necessarily need to be a large dealer. Rather, any dealer with a preponderance of active flow and relatively fewer resting orders will see a benefit from broker preferencing.

Large dealers are not necessarily the main beneficiaries of broker preferencing as some dealers have challenges in coordinating order flow from multiple sources and with a diversity of execution considerations. In the context of a fragmented marketplace with significant differences in execution costs, it can be difficult to achieve the coordination required to maximize the benefit of broker preferencing.

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

We believe the main benefits of broker priority accrue in the most liquid and most widely-quoted equities.

We believe the main determinant of the value of broker preferencing is the degree of fragmentation and the queue length on each marketplace. Thinly-traded equities will typically have less fragmented order books with shallower queues. As a result, the maximum possible amount of "queue jumping" from broker priority is less.

Conversely, liquid stocks tend to exhibit fragmented order books with deep queues. This phenomenon is particularly acute at lower price points, typically in the $1.00-$5.00 price range. In these situations, the market price changes relatively less frequently, quotes are generally deeper and more stable, and as a result it is difficult for resting orders to be filled from time priority alone. In these cases, broker preferencing provides a valuable benefit to resting orders originating at dealers who also have significant active order flow.

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?

We believe that the Marketplace Rules should not preclude dealers from automating workflows which could be done manually, or workflows which have been done manually in the past. This includes developing mechanisms that optimize routine decisions of intentionally crossing client orders which may be fully or partly represented in the marketplace, whether the activity involves facilitation capital or otherwise.

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On the other hand, we believe that mechanisms for holding large numbers of client orders away from the open market, and systematically seeking to find matches within those orders, is outside the scope of what could be done manually by dealer staff. Such systems are more closely aligned with the functions of marketplaces and should be subject to fair access requirements.

We note that while the "upstairs" block market consists of undisplayed trading interest, and dealers do seek to find matches within their network of clients. However, the Canadian "upstairs" block market typically functions on the basis of indications-of-interest and significant negotiation, involving a process for firming up indications and a "last look." Due to the inherent negotiation process involved in the block market, we do not believe it falls within the confines of the marketplace rules and the definition of a marketplace – whether the workflow is optimized through technology or conducted through verbal negotiations and telephones.

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?

We believe that, other than dealers' desire for natural client-to-client interaction, internalization is closely linked to choosing the segment of order flow which should be internalized (and conversely, the segments which shouldn't). Any internalization strategy involving commitment of capital to near-term trading will seek to interact with some types of flow (typically retail) and avoid others (typically institutional). As a result, we believe that segmentation and internalization are inextricably linked.

The dominant concern around internalization currently relates specifically to the practice of retail internalization, to the detriment of the non-retail community. The issues around "individual good" and "common good" expressed above relate primarily to what is left over if retail flow is removed from the broader market through systematic internalization. The "common good" is harmed if retail flow is cherry-picked away through systematic internalization. Any effort to balance the interests of the retail community against the interests of the "common good" will necessarily require making a determination of what degree of segmentation is appropriate.

Our views do not differ between segmentation achieved through various means. We believe that marketplace features such as retail guaranteed-fill facilities equally damage the "common good" by allowing a select set of participants to cherry-pick the retail flow which supports price discovery in the market. We are specifically concerned that the proliferation of competing guaranteed-fill facilities on multiple marketplaces have the potential to erode market quality in Canada.

We believe that a centralized facility for providing retail participants with "liquidity of last resort" may be a net benefit, on the condition that the design of this facility respects the interests of the market at large. We believe that such a facility should exhibit the following characteristics:

- The facility must offer a competitive means for liquidity providers (including natural investors) to participate.

- The facility would be available for additional liquidity only after all visible quotes are on all protected marketplaces are displaced.

In other words, a segmented retail-only facility would not be able to "step in front of" existing displayed orders, but would be able to provide size improvement to retail orders when deemed appropriate.

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?

We believe that the Canadian market structure and existing rule framework provide an appropriate environment for the execution of retail orders. Most discussions of retail execution focus on the use of the U.S. wholesaling model to overcome the costs of execution and offer size improvement. The cost aspect affects dealers more than it affect retail clients, whereas size improvement can be seen as incremental liquidity for retail customers

We believe that retail investors benefit from the overall Canadian equity market structure, including their contribution to price discovery. We therefore believe that regulatory decisions designed specifically to benefit retail investors must be taken very carefully. Such decisions would inevitably create a tradeoff between the "individual good" of the retail dealers and the "common good" of the market as a whole. Retail clients and their outcomes are part of the "common good" we seek to protect. Therefore, a regulatory outcome which favours retail at the cost of the "common good" could also do long-term harm to the very constituency which is intended to be helped.

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.

We are concerned that a two-tier structure, with specific measures for retail, will result in an environment with unintended consequences. Such a rule structure will favour a specific constituency's individual good against the broader considerations for the "common good."

To achieve better balance, we believe that certain specific adjustments to current practices are warranted. These include:

- The elimination of marketplace fee structures which discriminate on the basis of the type of counterparty.
- Introduction on specific limitations on exchange-operated guaranteed-fill facilities for retail customers – such as the framework described above.

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- Re-examining the thresholds for order exposure to ensure that the price discovery mechanism in Canada is preserved.

We believe the rule framework should avoid discriminating based on the nature of participants. We do not believe it is appropriate to distinguish retail investors from institutional, or tailor rules on the basis of whether an order is marked as "client" or "principal." Rather, we favour a structure where all orders of a similar characteristic (such as size) are treated similarly.

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

Dealer internalization, particularly of retail flow, is closely linked to the cost of execution in the open market. The practice of make-take pricing on some markets, and inverted pricing on others, creates significant incentives for dealers to match flow away from the broader markets and report to the market through intentional crosses.

Our view is that the fragmentation of flow through differential fee structures is at the core of the internalization debate. Notwithstanding the efficiency benefits of matching orders intra-dealer, the incentive to internalize as a cost-management strategy would be significantly diminished in an environment where the cost of execution in the open market is reduced. As a result, we do not believe that the practice of internalization can be considered without adequately addressing the cost of trading and the externalities of make-take pricing.

For further clarity, regulatory actions which increases the requirements for participants to pursue the "common good" at the expense of their individual economics will result in a greater incentive to find ways to manage costs.

We believe an optimal outcome for the Canadian market is an environment where all participants are able to balance off their own interest with the interest of the "common good." A holistic solution would require addressing all aspects of this complex issue. These include:

- The need to preserve and foster price discovery and liquidity.
- The incentive of dealers to route in a manner which allows them to maximize fills among clients.
- The requirement by all participants to seek best execution for their clients, which may result in outcomes which favour the "individual good" over the "common good."
- The cost of execution in the open market, including all associated costs (marketplace membership, market data, connectivity charges, etc.).

As Canadian market participants, we believe we all collectively have a shared duty to contribute to the greater whole.

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Toronto, ON M5H 1H1

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We appreciate the opportunity to comment on this important matter.

Respectfully,

Alex Perel, CFA
Head of ETF Services
Scotiabank Global Banking and Markets
(416) 862-3158
alex.perel@scotiabank.com