May 13, 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

Re: Consultation Paper 23-406

Before responding to some of the specific questions raised by the Consultation Paper, we open with two general comments on the consultation process itself and the U.S. versus Canadian context to this issue.

Complexity of the Consultation Process

This Consultation Paper is such an extensive questionnaire that we note the difficulty of responding in detail. We have heard from several industry participants that they feel they almost need to hire full-time researchers and writers to respond adequately to such documents. As a result, we believe the current consultation process may be biased towards large participants who can afford such staff, while smaller participants' voices will simply not be heard.

In order to make the consultation process more inclusive of smaller participants, we would strongly encourage the regulators to hold frequent formal *and* informal roundtables to sound out all industry participants on topics of concern. Such roundtables should include a representative cross section of market participants, ensuring all participants have an opportunity to be heard, and be held both prior to, and then following, the formulation and release of consultation papers. Such roundtables, with everyone sitting in one place at one time, would have a couple of benefits.

First, everyone in this industry "talks up their book" to some degree when writing comment letters. Having everyone discuss and debate issues live can often filter out what is simply self-interested lobbying versus sound policy proposals or observations.

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Second, such live meetings, when held prior to the release of consultation papers, could allay concerns regulators have with a particular issue before significant staff resources are invested into the writing consultation papers or rules changes.

U.S. versus Canadian Context

We sense that much of the regulatory concern with this topic is that many in the U.S. securities industry are also concerned with it. However, an important point of context is the fact that retail internalization, or wholesaling, and the resulting segmentation of retail order flow, is a far more significant factor in U.S. equity markets than it currently is in Canada. This point is stressed by academics in writing recently on this topic:

> "An empirical fact, not well known outside market microstructure circles, is that marketable retail orders in US equity markets are not typically executed on stock exchanges. Instead, these orders are routed to wholesale market makers and the retail brokers making these routing decisions receive payment for this order flow. This practice is commonly referred to as retail internalization and represents segmentation of retail order flow. Rosenblatt Securities estimates that retail internalization currently accounts for approximately 16 percent of consolidated U.S. equity market volumes."[1]

By engaging in this practice, broker-dealers who sell their retail client order flow for value are in turn able to charge clients significantly less in execution fees, with some even providing "free" execution. Unfortunately, clients are often blissfully unaware of the fact that such arrangements can result in the client paying significantly more/receiving less on their purchases/sales than they save in execution costs.

A class-action lawsuit against TD Ameritrade, certified in a Nebraska court in September 2018, alleges that this practice violates best execution obligations:

> "The plaintiff contends that defendant's order routing practices involve use of computer algorithms to send its customers' equity orders to venues that pay the defendant the most money, without regard to whether the venues would provide the best possible execution of those orders. The plaintiff further alleges defendant failed to disclose the practice to its customers. The plaintiff contends the practices are inconsistent with the defendant's duty of best execution and seeks remedies for violations of Section 10(b) and 20(a) of the Securities Exchanges Act of 1934, 15 U.S.C. §78a et seq. The plaintiff contends that the purported class suffers economic loss due to orders for securities trades being unfilled,

[1] See "Regulating Dark Trading: Order Flow Segmentation and Market Quality" by Carole Comerton-Fordea, Katya Malinova, and Andreas Park (September 3, 2016) at https://www.hec.ca/finance/Fichier/Malinova2016.pdf

underfilled, filled at a suboptimal price, and/or filled in a manner that adversely affects the order's performance post-execution."[2]

We raise this here to highlight that such retail internalization/wholesaling is a "made-in-America" controversy. By contrast, we in Canada have the UMIR 6.3 Order Exposure Rule that forces the vast majority of retail orders to be posted to marketplaces (or, if held up due to market conditions, to be traded at the best price or better). This feature of Canada's market structure means that Canadian discount brokerage services can never match their American counterparts in the offering of low- or zero-fee trading. This is something we will revisit in later responses to specific questions.

Question 1: How do you define internalization?

For the purposes of this consultation, we define internalization to mean simply the execution of client orders by a broker-dealer acting on both sides of the trade.

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, all six listed attributes (liquidity, immediacy, transparency, price discovery, fairness and market integrity) should be considered from a regulatory policy perspective.

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 results in segmentation of order flow which – as we expand on in response to Question 12 – impacts on several of these attributes.

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 that a market driven by fair access and with limited segmentation of order-flow should be able to satisfy both the common good and individual good. It is where access to liquidity is no longer fair, as will happen when order-flow is segmented, that conflicts between the common and individual good arise.

[2] See Memorandum and Order 8:14-CV-396 (filed September 14, 2018) at https://www.courthousenews.com/wp-content/uploads/2018/09/Ameritrade.CA_.pdf

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

Keeping in mind the prevalence of retail internalization in the U.S and given the fact that Canadian dealers compete with American brokers for trading in inter-listed stocks, the more a U.S. broker can subsidize the execution fees charged to clients by selling their order flow, the more the Canadian dealers are squeezed competitively. We recognize the cost savings on executions that can be achieved through broker-preferencing are a benefit to Canadian dealers in this competitive landscape.

While acknowledging that competitive benefit, we believe that broker-preferencing can negatively impact market fairness and integrity in situations where (a) a firm has knowledge of an incoming market/marketable client order and then (b) modifies one of its pre-existing contra orders to match the incoming order, with the result that broker preferencing allows that firm to "jump the queue" and trade against the client order on the open market.

So, for example, a stock is actively trading at a spread of $2.00 x $2.01 and the dealer places a series of small lot orders at slightly inferior prices; if the dealer had knowledge of an incoming client order to sell 1,000 shares at $2.00, the dealer could rapidly modify ("CFO") one of its inferior bids to 1,000 shares @ $2.00 and scoop up a trade that would have gone to another market participant.

We understand dealers are prohibited from sending a *new* order to interact with an incoming client order with knowledge of such order unless they provide price improvement – that is, they are knowingly trading as principal with their client and so fall under UMIR 8.1 Principal Trading. However, modifying the price and volume of a pre-existing order would seem, in substance, to be the same as entry of a new order (price and volume being the core attributes of any order) and so such practice should be similarly held to the standard of UMIR 8.1. Dealers are, of course, routinely audited for their client order handling, but this is a potential area of concern.

An abuse of broker preferencing that our firm *has* observed first-hand involves free-riding off another participant's price discovery. For example, Dealer B notices that Dealer A (or one of its clients) is making effective two-sided markets in a particular name. So Dealer B begins to mimic Dealer A's bids and offers at each relevant price level shortly after each Dealer A order is entered. Ordinarily, Dealer A would get the first fill at each price level and be rewarded for its (or its client's) contribution to price discovery, but because Dealer B has a large retail base, broker preferencing allows it to capture the benefit of its retail base reacting to Dealer A's initial price discovery.

Broker preferencing is inherently about trumping time-priority for the purpose of executing against one's own client order flow and thereby running contrary to the principle of price discovery. Although we accept this long-standing practice provides many dealers with a

significant opportunity to reduce client order execution costs, what it should not become is itself a *tool* a dealer uses to calibrate its trading strategies (as in the two examples provided above) in ways which undermine market fairness and integrity.

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

Broker preferencing results in one form of segmentation of order flow by having discrete sub-sets of the overall market interact first, at any given price level, within their own "pools" and then in accordance with time priority with the rest of the market. A dealer with a large retail investor base (retail investors being heavily skewed towards trading "actively" in sending market/marketable orders) will provide an obvious benefit to its clients that trade "passively", as compared to the execution capabilities of dealers with smaller retail investor flow. Smaller firms generally miss out on the "first look" afforded larger firms due to broker preferencing.

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

We believe that broker preferencing and the associated segmentation of order-flow will negatively impact the ability of the (few) remaining market making firms and other liquidity providers to profitably make markets in both liquid and illiquid securities, though direct impact will be more pronounced in liquid securities.

Given that such firms often rely on the profits generated in liquid names to subsidize their market making efforts in less liquid names where they make little or no profit, broker preferencing's direct impact on their profits in liquid names will put pressure on such firms' financial viability and their ability to continue making markets in low liquidity names.

We would argue that the potential disappearance of market makers from the less liquid names will have a pronounced negative impact on Canadian markets overall, and small- to mid-cap names in particular.

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?

Many dealers have consolidated their risk operations so that all client and principal orders route to what some call a "Central Risk Desk" or a "Central Risk Book". The principle is a sound one – since all orders going to market under on Broker ID ultimately resort to the firm's pool of capital, all such orders should be screened from one risk perspective.

However, we understand that some firms have gone further and developed algorithmic or automated ways of internally matching multi-party orders. Some of these may be executed as

crosses whereas others are simply sent out as marketable orders that will match to other client orders, or the firm's principal orders, due to the marketplace honouring broker preferencing. In other words, broker preferencing has become a tool used by the dealer to create an internal market, rather than merely a historical concession to allow it to minimize client execution costs.

We believe such systems are "marketplaces" as defined under NI 21-101. Each dealer's clients sends orders to it based on the firm's access to an interconnected OPR market regime, and each dealer holds itself out as providing such access. Yet, due to its size, were a large dealer to systematically and on an automated basis intercept and match many such client orders – even while using the crossing and broker preferencing features of marketplaces to do so – it has effectively created a two-tier market system and so violated the principle of fair access.

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 are generally against the segmentation of order flow, even for the ostensible goal of protecting or giving a leg-up to retail investors, because all order flow segmentation proposals are subject to the temptation of "cherry picking" the easiest orders to trade against and reduces fair access to all order flow.

Order flow segmentation starts to silo liquidity into discrete pools and by thinning out opportunities for the broadest degree of order interaction, reduces opportunities for trade execution. When this is combined with the ways in which broker preferencing can allow dealers to "jump the queue" as described in our response to Question 7, the results are undeniably negative for the (few) remaining market making firms and other liquidity providers.

We generally oppose marketplaces creating and sponsoring such segmentation. As for dealers doing so, we cannot tell a dealer how to interact with its own client base, but were a dealer to develop systematic and automated ways of internally matching orders, then we would have the same opposition to such segmentation.

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 Canada has unquestionably designed a better model than has the U.S. for maximizing price discovery to the benefit of all investors and trading firms. The pending case against TD Ameritrade highlights the controversy that surrounds retail internalization/wholesaling in the U.S. It is entirely possible that the outcome of the TD Ameritrade lawsuit is a dramatic reduction of retail internalization, bringing the U.S. closer to our own model.

However, with the widely known U.S. marketing efforts to retail investors involving low- or no-fee trading, we suspect that many Canadian retail investors believe they too ought to have cheap

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fees. Nothing is free, and cheap fees will always be cross-subsidized from some other activity affecting clients. While broker preferencing has provided Canadian dealers with a tool for reducing execution costs, we would urge the regulators to do more to educate retail investors as to the true cost of trading as opposed to creating more regulatory complexity to address a problem that seems to be far more of a problem in the U.S.

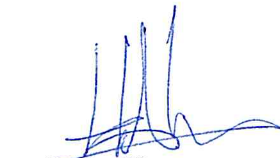
We believe the relatively heave reliance on the inverted maker-taker model in Canada, as compared to the U.S., is our industry's way of "selling" retail order flow given the effective UMIR prohibition on selling retail order flow the "American" way. In our firm's case, we are generally a large payer of fees on venues where active orders (typically from retail investors) are paid rebates; our traders value having such active flow "take" their offered liquidity. We have separately commented on why we believe the proposed Fee Pilot Study is a risky intervention into free markets, so any similar review of the inverted maker-taker model should start with an analysis of existing data/behavior.

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

As we have commented previously on the proposed Fee Pilot Study, direct intervention by regulators to set or limit prices is fraught with unintended consequences. Similarly, we believe that topics at issue should first be subjected to an analysis of available data and engagement in open discussions with all market participants. Such analysis and discussion should come before even considering the pursuit of pilot studies which are, in effect, experiments in live markets.

Sincerely,

Daniel Schlaepfer
President



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