

**Joint Canadian Securities Administrators/Investment Industry Regulatory  
Organization of Canada Position Paper 23-405**

**Dark Liquidity in the Canadian Market**

**I. Introduction**

Developments in the Canadian capital markets have been both significant and rapid in recent years. Technological advancements have increased the speed and complexity of trading, innovation has introduced choice as to how and where to trade, and regulatory requirements have necessitated a greater awareness of execution opportunities and the prices at which they are available.

As marketplaces look to expand the order types and features that they offer, and as market participants seek guidance on market structure policies, staff of the Canadian Securities Administrators (CSA staff) and staff of the Investment Industry Regulatory Organization of Canada (IIROC staff and, together with CSA staff, we) have undertaken a review of many of the issues which we believe need to be addressed immediately. These include issues relating to dark pools, electronic trading, and the regulation of marketplaces. Once our review is completed, we will seek feedback from the industry by publishing a number of different regulatory proposals or changes over subsequent months.

This position paper (Position Paper) specifically deals with issues associated with Dark Pools and Dark Orders.<sup>1</sup> The views expressed take into account the consultations conducted by the CSA and IIROC since the end of 2009.<sup>2</sup>

For the purposes of this Position Paper, a Dark Order is defined as any order on any marketplace that is entered with no pre-trade transparency and not required to be reported to an information processor<sup>3</sup> or data vendor under the applicable rules. In this Position Paper, Dark Orders do not include reserve or iceberg orders, as a portion of these orders is always displayed, and contributes to the pre-trade price discovery process. Dark Orders can be entered on either a transparent marketplace or in a Dark Pool. A Dark Pool is a specific marketplace that offers no pre-trade transparency on any orders, and may be structured in a variety of ways including as a call market, continuous auction market, a hybrid of both continuous and call matching, or a negotiation system. Current practices allow Dark Orders to be entered with a price:

- determined by the marketplace participant<sup>4</sup> entering the order;
- that could trigger a negotiation process; or
- that will be determined by reference to another publicly available price and not directly determined by the counterparties to the trade. The reference price could be a price linked to another non-discretionary price such as the national best bid or best offer (NBBO)<sup>5</sup> or the volume weighted average price (VWAP).

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<sup>1</sup> Note that for purposes of this paper, our definition of Dark Order is different than was used in previous publications. See glossary for all definitions.

<sup>2</sup> For more details regarding the consultations, see the discussion in the next section regarding the Consultation Paper and the Forum.

<sup>3</sup> Currently, the information processor for exchange-traded securities other than options is operated by the Toronto Stock Exchange. The information processor collects order and trade information from all marketplaces and disseminates consolidated information.

<sup>4</sup> Section 1.1 of *Regulation 21-101 respecting Marketplace Operation* (Regulation 21-101) defines “marketplace participant” as: “a member of an exchange, a user of a quotation and trade reporting system, or a subscriber of an ATS.”

<sup>5</sup> For the purposes of this paper, “national best bid or offer” and “NBBO” will refer to the “best bid price” and “best ask price” as defined in UMIR.

**(a) Background and Objectives of this Position Paper**

The publication of this Position Paper is the next step in a process that we began in late 2009. In *Joint CSA/IROC Consultation Paper 23-404 Dark Pools, Dark Orders, and Other Developments in Market Structure in Canada*<sup>6</sup> (Consultation Paper), we identified and sought comment on a number of issues, particularly the general impact of Dark Pools, the introduction of Dark Order types, and the introduction of smart order routers. The Consultation Paper discussed these issues and their potential impact on the Canadian markets, including their impact on market liquidity, transparency, price discovery, fairness and integrity.<sup>7</sup> These factors, when taken together, are used to assess the quality of the market.

We received 23 response letters to the Consultation Paper from a range of respondents including marketplaces, buy-side and sell-side representatives, and industry associations. On March 23, 2010, the CSA and IROC hosted a forum (the Forum) to discuss the issues raised in the Consultation Paper and in the response letters. The themes discussed at the Forum included:

- whether Dark Pools should be required to provide price improvement and if so, what is meaningful price improvement;
  - the use of market pegged orders and whether those orders “free-ride” off the visible market;
  - the use of sub-penny pricing;
  - broker preferencing at the marketplace level and dealer internalization of order flow;
  - the use of Indications of Interest (IOIs) by Dark Pools to attract order flow;
- and
- the fairness of a marketplace offering smart order router services that use marketplace data that is not available to other marketplace participants.

More details regarding the Forum were included in *Joint CSA/IROC Staff Notice 23-308 Update on Forum to Discuss CSA/IROC Joint Consultation Paper 23-404 “Dark Pools, Dark Orders and Other Developments in Market Structure in Canada” and Next Steps* published on May 28, 2010. This notice included a discussion of ongoing initiatives, proposed next steps to address some of the issues, and a summary of the comments received in response to the Consultation Paper.

After considering the response letters and discussions that occurred over the past few months, we are now publishing this Position Paper on the structure of Dark Pools and the use of Dark Orders, and are seeking additional feedback. This paper sets out our position in respect of the following questions:

- Under what circumstances should Dark Pools or marketplaces that offer Dark Orders be exempted from the requirements of pre-trade transparency under Regulation 21-101?
- Should Dark Orders be required to provide meaningful price improvement over the NBBO, and under what circumstances?
- Should visible (lit) orders have priority over Dark Orders at the same price on the same marketplace?

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<sup>6</sup> Published in the Bulletin de l’Autorité des marchés financiers, Vol. 6, No. 39 at page 236.

<sup>7</sup> See the Consultation Paper at pages 240-241.

- What is a “meaningful” level of price improvement?

A number of the issues raised at the Forum are not being addressed in the Position Paper. Specifically, the use of IOIs by Dark Pools to attract order flow and the fairness of a marketplace offering smart order router services that use marketplace data that is not available to other marketplace participants will be addressed in a separate CSA project that will update the requirements applicable to alternative trading systems (ATSs) and exchanges (the ATS-Exchange Project).<sup>8</sup>

In addition, the Position Paper does not include a position on the practice of broker preferencing. Broker preferencing is a marketplace feature that allows orders from the same participant or subscriber to execute ahead of other orders posted at the same price in the limit order book. In responses to the Consultation Paper and at the Forum, some argued that broker preferencing is inherently unfair while others argued that it has been a part of the Canadian market for years and has had no negative impact on the market.

It is the opinion of staff that, at this point, we do not have sufficient data with respect to broker preferencing to properly formulate a position with respect to its impact on the Canadian market. We will in the near future publish a request for information in order to better evaluate broker preferencing and its impact.

#### **(b) Summary of Our Position**

We are of the view that, in order to facilitate the price discovery process, orders entered on a marketplace should generally be transparent to the public and subject to the pre-trade information transparency requirements as detailed in Regulation 21-101, section 7.1. However, we recognize that there are benefits to using Dark Orders, whether on a transparent marketplace or a Dark Pool. In our view:

- An exemption to the pre-trade transparency requirements should only be available when an order meets or exceeds a minimum size (in the Position Paper, we will refer to this as the “minimum size exemption” or “minimum size threshold”). This minimum size threshold for posting passive Dark Orders would apply to all marketplaces (whether transparent or a Dark Pool) regardless of the method of trade matching (including continuous auction, call or negotiation systems), and for all orders whether client, non-client or principal.

- Dark Orders should only be required to provide meaningful price improvement over the NBBO when executing with an active order which does not meet the minimum size exemption. There should be no price improvement requirement on two Dark Orders meeting or exceeding the minimum size exemption.

- Visible orders should execute before Dark Orders at the same price, on the same marketplace, except where two Dark Orders meeting the minimum size exemption can be executed at that price.

- Meaningful price improvement should be one trading increment as defined in IIROC’s Universal Market Integrity Rules (UMIR).<sup>9</sup> However, for securities with a difference between the best bid price and best ask price of one trading increment, one-half increment will be considered to be meaningful price improvement.

Our analysis of each of these points is included in Section II of this Position Paper.

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<sup>8</sup> The proposed revisions, which we expect to publish early 2011, would provide clarity on when an IOI would be considered an order and thus be subject to the transparency requirements of Regulation 21-101, and will clarify the expectation that marketplaces consider fair access requirements when sending marketplace data to a smart order router but not to other marketplace participants.

<sup>9</sup> UMIR Rule 1.1 defines a “trading increment”. UMIR Rule 6.1 (1) states: “No order to purchase or sell a security shall be entered to trade on a marketplace at a price that includes a fraction or a part of a cent other than an increment of one-half of one cent in respect of an order with a price of less than \$0.50.”

By expressing our views on Dark Orders, we are providing more clarity around how Dark Orders should be treated in the Canadian market and are facilitating investor understanding and choice regarding the execution of their orders. We recognize that our position will impact existing business models and lead to systems changes. However, in examining the issues and the risks of the expansion of the use of Dark Orders, we are of the view that the need for providing some limits on their use is critical in maintaining the quality of the price discovery mechanism and addressing concerns regarding the impact of Dark Orders on the quality of the Canadian capital market. In addition, some investors will be impacted by the positions taken in this paper. Our intention is to maintain the ability to execute large orders while managing market impact costs, and for smaller orders to continue to interact in Dark Pools with liquidity that may not have otherwise been available, subject to the requirement for meaningful price improvement.

We are seeking comments on our position and, at the end of this Position Paper, we provide details on how comments can be provided.

### (c) **International Developments Relating to Dark Liquidity**

Many jurisdictions are currently examining issues related to dark liquidity and its impact on markets. For example, in the United States, the SEC published, in 2009, a consultation paper that discusses regulatory issues surrounding dark pools.<sup>10</sup> In 2010, the SEC published a concept paper that covers a number of market structure issues, including issues related to dark liquidity.<sup>11</sup>

In Europe, Directive 2004/39/EC, promulgated under the Markets in Financial Instruments Directive (MiFID), is currently being reviewed by the European Commission and the Committee of European Securities Regulators (CESR). As part of its own review, CESR recently published a consultation paper<sup>12</sup> on equity markets which includes, among other things, the examination of existing pre-trade transparency waivers provided under MiFID and policy options regarding crossing systems and processes operated by investment firms. In July 2010, CESR published a report<sup>13</sup> in which it recommends, among others, that the existing exceptions to pre-trade transparency should continue to be allowed under certain circumstances, and that the European Commission undertake or commission further analytical work regarding the existing thresholds.

In Australia, the Australian Securities & Investments Commission (ASIC) released, on November 4, 2010, a consultation package on enhancing the regulation of Australia's equity markets, including rule proposals aimed at developing the regulatory framework to support competition in the Australian market. This consultation package comprises Consultation Paper 145 *Australian equity market structure* (CP 145) and ASIC's Report on the *Australian equity market structure*<sup>14</sup> and includes, among others, regulatory proposals for minimum disclosure requirements of order and trade information. Relevant to this Position Paper are rule proposals that would require that market participants display orders on pre-trade transparent markets, subject to certain exceptions generally relating to large-sized orders.

On October 27, 2010, the Technical Committee of the International Organization of Securities Commission (IOSCO) issued a consultation report (IOSCO report) that requests

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<sup>10</sup> SEC Release no. 34-60997, *Regulation of Non-Public Trading Interest*, November 2009, available at <http://www.sec.gov/rules/proposed/proposedarchive/proposed2009.shtml>.

<sup>11</sup> SEC Release no. 34-613358, *Equity Market Structure*, January 2010, available at <http://www.sec.gov/rules/concept.shtml>.

<sup>12</sup> CESR consultation paper ref: CESR/10-394, *CESR Technical Advice to the Commission in the Context of the MiFID Review – Secondary Markets*, April 2010, available at [http://www.cesr-eu.org/index.php?page=consultation\\_details&id=161](http://www.cesr-eu.org/index.php?page=consultation_details&id=161).

<sup>13</sup> *CESR Technical Advice to the European Commission in the Context of the MiFID Review – Equity Markets*, July 2010, available at [http://www.cesr-eu.org/index.php?page=document?details&from\\_title=Documents&id=7003](http://www.cesr-eu.org/index.php?page=document?details&from_title=Documents&id=7003).

<sup>14</sup> Published at: [http://www.asic.gov.au/asic/asic.nsf/byHeadline/10-227MR%20ASIC%20consults%20on%20equity%20market%20structure%20regulatory%20framework?open\\_document](http://www.asic.gov.au/asic/asic.nsf/byHeadline/10-227MR%20ASIC%20consults%20on%20equity%20market%20structure%20regulatory%20framework?open_document).

comment on a number of proposed principles relating to dark liquidity.<sup>15</sup> The principles relate to:

- pre-trade transparency;
- post-trade transparency;
- the priority of transparent orders;
- reporting to regulators;
- information available to market participants regarding dark pools and dark orders; and
- the regulation of the development of dark pools and dark orders.

Generally, the current regulatory structure in Canada and the views taken in this Position Paper are consistent with the principles proposed by the Technical Committee. For example, the current regulatory structure requires immediate post-trade reporting of executions in dark pools and of dark orders. In addition, we have a number of incentives with respect to fostering trading in transparent orders, including the Order Protection Rule and the Order Exposure Rule. Both the CSA and IIROC have the ability to access order and trade information in dark pools and marketplaces file quarterly information regarding volumes with the CSA.

We currently require priority of visible orders over dark orders on the same marketplace at the same price, which is also consistent with one of the proposed principles. However, we are proposing to allow two large orders that are “marked dark” to execute prior to visible orders on the same marketplace at the same price. While this is different from the IOSCO report, we think it is important to explore and obtain feedback on this exception.

## **II. Analysis**

### **(a) Regulatory Structure Relating to Dark Pools and Dark Orders**

We think that it is helpful to briefly summarize the regulatory structure and current rules on Dark Pools and Dark Orders on transparent marketplaces.

Dark Pools are generally regulated as alternative trading systems (ATS) under Regulation 21-101, and are registered as investment dealers. They may, however, be operated and regulated as a facility of a recognized exchange. In either case, Dark Pools are subject to the provisions of Regulation 21-101 and *Regulation 23-101 respecting Trading Rules* (Regulation 23-101). Requirements applicable to Dark Pools include fair access requirements, post-trade transparency requirements, systems requirements, and the requirement to retain a regulation services provider to conduct market regulation if regulated as an ATS. In addition, Dark Pools are required to file Form 21-101F2, if operated as an ATS. If operated as a facility of an exchange, the exchange must file Form 21-101F1. These forms require information with respect to the operation of the Dark Pool and a description of its order types. Trading on a Dark Pool is also subject to UMIR requirements regarding trading on marketplaces, best execution, best price and the exposure of orders.

When reviewing a marketplace’s rules proposal, an exchange’s Form 21-101F1 filings or an ATS’s Form 21-101F2 filings, we review the proposed market structure and order types to determine if they pose market integrity concerns, support a fair and efficient market, and foster investor confidence.

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<sup>15</sup> Available at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD336.pdf>.

Under Regulation 21-101, marketplaces that display orders are subject to pre-trade transparency requirements.<sup>16</sup> Orders are not considered to be “displayed” if they are shown only to employees of the marketplace or persons or companies retained to assist in the operation of the marketplace.<sup>17</sup> It is under these provisions that Dark Pools are permitted to operate and Dark Order information is not required to be provided to the information processor for dissemination. However, post-trade information is reported to the information processor in real-time once the orders are executed.

Rule 6.3 of UMIR (the Order Exposure Rule) states that “A participant shall immediately enter on a marketplace that displays orders ... a client order to purchase or sell 50 standard trading units or less of a security ....”<sup>18</sup> Aside from the specific exemptions under the Order Exposure Rule, it is currently required that client orders with a quantity equal to or less than 50 standard trading units will be directed to a transparent marketplace in order to be displayed. The Order Exposure Rule encourages transparency and supports the price discovery process, while still providing an opportunity for dealers to minimize large, passive order information leakage. Price discovery is enhanced by requiring smaller passive orders to be posted in a visible marketplace and rewarding those orders with increased execution opportunities. Additionally, IROC has provided guidance in Market Integrity Notice 2007-019 with respect to the entry of client orders on non-transparent markets or facilities.<sup>19</sup>

## **(b) General Considerations**

In reviewing issues related to Dark Pools and Dark Orders, we identified a number of key questions which shaped our discussions and formed the basis for our position and recommendations. They are:

- What is the rationale for permitting Dark Pools and Dark Orders in general?
- What benefits do Dark Pools and Dark Orders provide to capital market participants?
- What are the risks to the Canadian capital market?
- Should incentives exist that favour transparency and the price discovery process?

We discuss each below.

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<sup>16</sup> Subsection 7.1(1) of Regulation 21-101.

<sup>17</sup> Subsection 7.1(2) of Regulation 21-101.

<sup>18</sup> UMIR Rule 6.3 *Exposure of Client Orders* requires that “an order for 50 trading units or less must be immediately entered on a transparent marketplace unless otherwise exempted. Permitted exemptions include:

- a) if the client has specified different instructions;
- b) if the order is executed immediately at a better price;
- c) if the order is returned for the terms of the order to be confirmed;
- d) if the order is withheld pending confirmation that the order complies with applicable securities requirements;
- e) if entering the order based on market conditions would not be in the interests of the client;
- f) if the order has a value greater than \$100,000;
- g) if the order is part of a trade to be made in accordance with Rule 6.4 by means other than entry on a marketplace; or
- h) if the client has directed or consented that the order be entered on a marketplace as a Call Market Order, an Opening Order, a Special Terms Order, a Volume-Weighted Average Price Order, a Market-on-Close Order, a Basis Order, or a Closing Price Order.”

<sup>19</sup> Market Integrity Notice 2007-019, issued September 21 2007 by (then) Market Regulation Services Inc. (RS) states in part “In the view of RS, client orders which are routed to a non-transparent marketplace or facility to determine if liquidity is available on that marketplace or facility at prices that are the same or better than displayed in a consolidated market display would comply with the requirements of Rule 6.3 provided any unexecuted portion of the client order was then immediately entered on a marketplace that did provide order transparency.”

**(i) Rationale and Benefits of Dark Pools and Dark Orders**

Initially, Dark Pools were introduced to enable investors to place large orders anonymously without displaying them to the public in order to minimize the market impact costs associated with placing such large orders in a visible book.<sup>20</sup> This could be achieved through institutions trading large volumes among each other anonymously, or through large orders that may have otherwise traded only in the upstairs market, being entered on a marketplace where they can interact with orders from other investors without being displayed. It has been suggested that by allowing large orders to interact within Dark Pools, there would be an increase in the overall liquidity in the market, as these large orders would have otherwise traded in the upstairs market. This increased liquidity could benefit all investors, including retail investors, who would not otherwise have had access to this liquidity. Similarly, the introduction of Dark Order types on transparent marketplaces ensures that the existence of the order remains confidential, which decreases the order's market impact costs.

However, the rationale for using Dark Orders has evolved. There has been an expansion of their use to include orders of all sizes, small or large. Dark Pools or Dark Orders are also used to protect proprietary trading information, avoid algorithms that are used to identify order parameters and trading strategies, take advantage of possible price improvement, and potentially incur lower trading fees. In some jurisdictions, Dark Pools have also evolved to enable dealers to internalize order flow.

Additionally, Dark Orders are often given the opportunity to execute with contra-side order flow which is either routed to a transparent market, or routed to pass through a Dark Pool (Liquidity-Seeking Orders). This opportunity provides the Liquidity-Seeking Orders, which are generally smaller-sized orders, a chance to receive price improvement over the NBBO.

**(ii) Risks of Dark Pools and Dark Orders**

Widespread use of Dark Orders has the potential to reduce available liquidity in transparent order books. While there may be benefits to investors, including the potential to receive price improvement, if orders that would traditionally be sent to visible marketplaces are increasingly diverted to Dark Pools or entered as Dark Orders there could be a negative impact on the price discovery process and the liquidity available to those participants that are required to, or have elected to, display their orders on a visible market.

**(iii) Incentives to Contribute to Price Discovery**

The price discovery process is a fundamental building block of a fair and efficient market.<sup>21</sup> Accordingly, there are a number of incentives that exist in the Canadian market that promote the posting of limit orders in a visible book. They include:

- best price and order protection obligations<sup>22</sup> that ensure only visible orders are protected. Better-priced, non-visible orders may be traded through as inferior-priced visible orders are executed first;
- the priority of visible orders over Dark Orders at the same price, on the same marketplace; and
- the Order Exposure Rule which requires that participants immediately enter on a marketplace that displays orders, all client orders for 50 standard trading units or less, subject to a number of exceptions. This is a benefit gained by passive, displayed orders in a transparent order book, in that active orders not meeting the size conditions of the rule are

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<sup>20</sup> See Consultation Paper at page 236.

<sup>21</sup> See discussion in Consultation Paper at page 241.

<sup>22</sup> The Order Protection Rule is effective on February 1, 2011 (see Regulation 23-101, Part 6). Best Price obligations are detailed in UMIR 5.2.

obligated to be routed to a transparent market, thus increasing the chances of execution for the displayed order.

The posting of limit orders in a visible book is important to maintain the quality of price discovery. To achieve this, limit orders should ideally be directed to, and displayed in visible marketplaces in order to facilitate the price discovery process.

**(c) Recommendations**

In light of the questions discussed above, the following section outlines our position on how we believe Dark Pools and Dark Orders should be treated within the framework of the Canadian market.

**(i) Minimum Size Exemption**

One of the issues raised in the Consultation Paper as well as at the Forum was whether orders in Dark Pools and Dark Orders on transparent markets should be required to be of a minimum size and whether smaller orders should be able to rest in Dark Pools or as Dark Orders on transparent marketplaces.

As stated earlier, an important part of the initial rationale behind the existence of orders with no pre-trade transparency was to allow larger orders to be executed with decreased market impact costs. However, as the “market impact cost” rationale described above may be less relevant to small Dark Orders, a possible rationale for allowing smaller orders to be posted as Dark Orders and be exempted from pre-trade transparency requirements is that they offer price improvement over the NBBO.

While small orders may provide some price improvement when posted as a Dark Order, the limited quantity diminishes the value of price improvement to all market participants when compared to the value, or net benefit, of having larger Dark Orders offering the same price improvement, as well as providing much greater amounts of liquidity to the market as a whole. Currently in Canada, there are Dark Pools or Dark Order types that offer as little as 10% price improvement over the NBBO. In the situation where the NBBO spread for a particular security is very small (for example, one penny), we question whether the price improvement provided by small non-transparent orders is sufficiently meaningful for contra-side participants. If not, should these small orders be displayed on visible marketplaces? Does the benefit of receiving price improvement outweigh the potential impact on price discovery of those smaller orders not being displayed on a transparent marketplace?

In addition, in our view, two objectives need to be considered in examining whether small orders should be able to be posted as Dark Orders without detriment to market quality. They are (i) to encourage the posting of visible orders, and (ii) to expose as much liquidity as possible to the widest variety of contra-side participants, including those using Dark Pools.

*Staff's View*

**The only exemption to pre-trade transparency should be for orders that meet a minimum size threshold.**

It is our view that the potential negative impact on price discovery of a greater number of small orders being entered without pre-trade transparency and the potential drain on visible liquidity outweighs the benefits of the possible price improvement that they may offer. While post-trade information contributes to the price discovery mechanism, pre-trade transparency is an important element. The risk of a significant erosion of the quality of that mechanism exists if a substantial number of small orders are posted in the dark. As regulators, part of our mandate is to foster fair and efficient capital markets. The requirements to post small orders to a visible market and facilitating price discovery are key components of fair and efficient capital markets.

Consequently, we are of the view that an exemption from the pre-trade transparency requirements should only be available for orders meeting the minimum size threshold. At this stage, we have yet to establish this minimum size; however, as an example, we would consider a minimum size comparable to that referenced in the Order Exposure Rule (50 standard trading units). We are requesting specific feedback with respect to the appropriate order size required to meet the exemption.

Furthermore, marketplace participants should not aggregate orders to meet the minimum size threshold and, once posted, orders should not be changed to a quantity less than the minimum size. However, if a Dark Order meeting the minimum size threshold receives a partial fill which results in the remaining balance being less than the size threshold, that order should be able to continue to remain dark until cancelled or fully executed.

Our view is consistent with the initial rationale for the introduction of Dark Pools and Dark Order types in general, which was to facilitate the execution of large orders and to enable more participants to interact with previously unavailable liquidity. By restricting pre-trade transparency exemptions to Dark Orders meeting a minimum size, we will allow larger sized orders that might be traditionally held back from the markets to take advantage of the benefits of being fully dark. However, small liquidity providing orders will be directed to the visible order books, and are still given the added incentive of protection from trade-through by existing rules and the pending Order Protection Rule.

To implement this position, we will include a proposed exemption from section 7.1 of Regulation 21-101 as an amendment to Regulation 21-101 that we will publish as part of the ATS -Exchange Project and which CSA staff expect to publish in early 2011.

*(ii) Dark Orders and Price Improvement*

Another issue raised in the Consultation Paper is whether Dark Orders should be required to offer price improvement over the NBBO and in which circumstances. In examining the issues surrounding Dark Orders executing at the NBBO, we need to consider the same two objectives as mentioned above. We want to encourage posting of visible orders and encourage the exposure of orders to as much liquidity as possible, including Dark Orders. Visible orders posted on a transparent marketplace are an integral part of the price discovery mechanism and setting the NBBO. It is also important to create a structure where large orders are able to interact with smaller orders. However, the analysis in this case would be incomplete without considering the value or benefit of two large orders executing against each other and contributing to the price discovery process through immediate post-trade transparency.

*Staff's View*

**Two Dark Orders meeting the minimum size exemption should be able to execute at the NBBO. Meaningful price improvement should be required in all other circumstances, including all executions with orders not specifically marked in a manner indicating they are utilizing the minimum size exemption.**

The execution of Dark Orders meeting the pre-trade minimum size exemption still contributes to the price discovery process through immediate post-trade transparency. Additionally, the size of the transaction may provide sufficient information to participants to stimulate further trading that might not otherwise have occurred in the absence of such a large-sized execution. In our view, the contribution of this post-trade information as well as the need to protect against market impact costs both justify allowing the execution of Dark Orders without price improvement in certain circumstances.

Therefore, it is our view that two Dark Orders should be allowed to trade at the NBBO provided that both sides of the trade meet the minimum size threshold, and that meaningful price improvement should be provided by Dark Orders in all other circumstances. We note that both orders trading at the NBBO must be specifically marked in a manner which indicates the intention to utilize the pre-trade transparency exemption (i.e. both orders must be marked as “dark”).

We believe this satisfies the objectives of exposing liquidity to the widest variety of contra-side participants and encouraging the posting of visible orders. We want to create an incentive to display orders, but we recognize that Dark Orders can play an important role for both price and size discovery, and that it is important to give market participants a method to trade in large size without penalizing them by requiring price improvement in all cases. It offers the ability to execute large- sized orders at the NBBO; however, it protects the quality of our visible order books by encouraging smaller market or marketable limit orders to execute with visible liquidity at the NBBO, and to seek price improvement offered by Dark Orders posted inside the spread.

In its *Concept Release on Equity Market Structure* (January 13, 2010)<sup>23</sup>, the Securities and Exchange Commission in the United States discussed and requested comment on extending visible order priority across all marketplaces through the introduction of a “trade-at” rule. This rule would require all visible orders at the same price across marketplaces to be executed prior to the execution of dark orders, unless certain conditions were met. We are not proposing a “trade-at” rule to apply across marketplaces in this Position Paper. We will continue to monitor the progress of the discussions in the United States on this and other issues.

**(iii) Execution Priority at the NBBO**

In the Consultation Paper, we asked if marketplaces should be required to provide execution priority to visible orders over Dark Orders at the same price. The vast majority of respondents and Forum participants thought that visible orders should be given priority over Dark Orders at the same price for a number of reasons including:

- market participants taking the risk to display their order should be rewarded by being given priority; and
- the promotion of pre-trade price discovery and visible liquidity.

*Staff's View*

**Visible orders on a marketplace should execute before Dark Orders at the same price on the same marketplace. However, an exception could be made where two Dark Orders meeting the minimum size threshold can be executed at that price.**

It is our view, as it has been historically, that visible orders on a particular marketplace should be given priority over Dark Orders at the same price. We believe this is fundamental to the protection of the price discovery process, and of the visible liquidity displayed in marketplaces' limit order books. However, it is also our opinion that two Dark Orders meeting the minimum size exemption and transacting at the NBBO make a significant contribution to price discovery and provide a benefit to marketplace participants through immediate post-trade transparency. Therefore, we would allow an exception to the priority of visible orders executing before Dark Orders at the same price on the same marketplace where two Dark Orders meeting the minimum size and appropriately marked as exempt from pre-trade transparency requirements can be executed at that price.

<sup>23</sup>

Published at: <http://www.sec.gov/rules/concept/2010/34-61358.pdf>.

We recognize that investors with small orders in the visible book may be concerned about losing execution priority to large Dark Orders. However, it is our intent to not only protect the quality of our visible order books, but to facilitate greater liquidity interacting with more contra-side participants. This provides investors with a greater ability to get their orders executed. We believe that our current multiple marketplace structure provides a sufficiently robust environment for trading smaller-sized orders by enabling them to interact with a substantial number of liquidity-providing participants. Therefore, we feel that the price discovery benefits provided by the execution of two appropriately marked, large Dark Orders is significant enough to justify an exception to the traditional priority rules.

*(iv) Meaningful Price Improvement*

In the Consultation Paper, we discussed price improvement and asked whether transparent marketplaces should be allowed to have fully-hidden orders posted at prices inside the prevailing spread. There was no consensus on the issue in the response letters. Some commenters believed that fully-hidden orders should be allowed to post inside the prevailing displayed spread to (i) offer price improvement, and (ii) promote innovation by marketplaces. Others, however, thought transparent marketplaces should only allow execution of orders at the best bid or at the best offer. Some are of the view that, in order for orders to be executed inside the NBBO spread, they should provide meaningful price improvement.

The question then arose as to what is considered to be “meaningful”. At what point does the individual benefit to an order receiving price improvement become less than the cost to the market as a whole when increasing numbers of orders are removed from visible marketplaces? Is price improvement amounting to fractions of a penny meaningful enough to justify a Dark Order trading in front of visible orders?

*Staff’s View*

**Meaningful price improvement means that the price is improved over the NBBO by a minimum of one trading increment as defined in UMIR, except where the NBBO spread is already at the minimum tick. In this case, meaningful price improvement would be at the mid-point of the spread.**

It is our view that the ability to obtain price improvement at a fraction of a penny for a small number of shares does not outweigh the need to protect and foster the visible market and the price discovery process. The costs to all participants in the market, including investors, and regulators if sub-penny pricing were permitted outweigh the benefits of such small price improvement. The potential costs include the opportunity cost of missing the execution of an order due to sub-penny quote jumping, and increasing technology costs associated with execution, data, compliance and regulation that would affect marketplaces, marketplace participants, investors and regulators.

Consequently, we are of the view that meaningful price improvement should require that the price be improved over the NBBO by a minimum of one trading increment (tick) as defined in UMIR.

The price improvement requirement provides a benefit to both the order receiving price improvement and the passive orders in the visible books in the form of greater protection against sub-penny quote jumping. These orders are often those of the retail investor.

However, many securities are often already quoted at the narrowest spread allowable under UMIR. In a situation where the spread is already at the minimum tick, meaningful price improvement should be at the mid-point of the spread. In these cases, the Dark Order will have to be entered with reference to the NBBO in order to accommodate a mid-point execution. This is because, under UMIR, orders are not permitted to be entered

in sub-penny prices except for securities trading at less than \$0.50, for which orders in half-cent increments are currently permitted.

We believe a balance is needed between fostering competition for execution and keeping spreads narrow, and avoiding encouraging increasingly smaller amounts of price improvement used solely to achieve execution in front of visible orders. In keeping with the initial reasoning for the existence of Dark Pools (and more recently Dark Orders in general), we need to differentiate between two very different interests: (i) a genuine desire for large order execution, that can be reflected by a willingness to provide price improvement over the NBBO and the acceptance of this as a cost associated with the benefits of keeping an order dark; and (ii) the desire to step in front of a displayed quote for as tiny an amount as is permitted, merely to capture incoming order flow. For orders in securities trading at the minimum spread, a mid-point match allows the price improvement to be shared equally by both sides of the trade. We believe that this is a reasonable outcome that benefits both the Dark Order and the incoming order looking for price improvement.

### **III. Comment Process and Next Steps**

The issues addressed in this Position Paper are important ones which affect all participants in the Canadian capital market. Our recommendations reflect our views and are based on feedback from consultation with marketplace participants received not only through the comment process of the Consultation Paper and the Forum, but also from ongoing discussion with various stakeholders. Due to the broad impact of these proposed changes, we invite all interested parties to make written submissions. We ask that, to the extent possible, such written submissions be accompanied by supporting information and data.

Once we have considered feedback received, we will propose the appropriate rule changes that will be needed. Such rules may be at the CSA level, for example through amendments to Regulation 21-101, or at the IIROC level, for example through amendments to UMIR. Any rule proposal will be published for comment in accordance with the regular process.

Submissions to the CSA should be addressed on or before January 10, 2011 in care of the OSC, in duplicate, as indicated below:

Alberta Securities Commission  
British Columbia Securities Commission  
Manitoba Securities Commission  
Autorité des marchés financiers  
New Brunswick Securities Commission  
Superintendent of Securities, Government Services of Newfoundland and Labrador  
Superintendent of Securities, Department of Justice Government of Northwest Territories  
Nova Scotia Securities Commission  
Superintendent of Securities, Nunavut  
Ontario Securities Commission  
Superintendent of Securities, Consumer, Corporate and Insurance Services, Office of the Attorney General, Prince Edward Island  
Saskatchewan Financial Services Commission  
Superintendent of Securities, Yukon

c/o John Stevenson, Secretary  
Ontario Securities Commission  
20 Queen Street West  
Suite 1900, Box 55  
Toronto, Ontario M5H 3S8  
E-mail: [jstevenson@osc.gov.on.ca](mailto:jstevenson@osc.gov.on.ca)

and

M<sup>c</sup> Anne-Marie Beaudoin  
Corporate Secretary  
Autorité des marchés financiers  
800, square Victoria, 22<sup>e</sup> étage  
C.P. 246, tour de la Bourse  
Montréal (Québec) H4Z 1G3  
e-mail:consultation-en-cours@lautorite.qc.ca

Submissions to the Investment Industry Regulatory Organization of Canada to:

James Twiss – Vice President, Market Regulation Policy  
Kevin McCoy – Senior Policy Analyst, Market Regulation Policy  
Investment Industry Regulatory Organization of Canada  
Suite 1600  
121 King Street West  
Toronto, Ontario  
M5H 3T9  
Email: jtwiss@iiroc.ca/kmccoy@iiroc.ca

We cannot keep submissions confidential because securities legislation in certain provinces requires that a summary of the written comments received during the comment period be published.

Questions may be referred to any of:

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## Glossary

**Broker Preferencing:** A marketplace feature that allows orders from the same participant or subscriber to execute ahead of other orders posted at the same price in a central limit order book.

**Call Market:** A market in which each transaction takes place at pre-determined time intervals and where all of the bid and ask orders are aggregated and transacted at once. The marketplace determines the market clearing price based on the number of bid and ask orders. The market clearing price is the price at which the most number of orders will trade.

**Dark Pool:** A marketplace that offers no pre-trade transparency on any orders.

**Dark Order:** An order on any marketplace which is entered with no pre-trade transparency.

**Indications of Interest (IOI):** IOIs include messages sent from a marketplace that contain certain information about resting orders on that marketplace. Information contained in an IOI may include information on one or more of, but not all of; symbol, side, size or price.

**Liquidity Seeking Orders:** “Active” orders passing through a Dark Pool on the way to another marketplace, or interacting with liquidity on a transparent marketplace.

**Market Impact Costs:** The costs that are incurred when the execution of an order moves the price of that security above the target price for a buy order, or below the target price for a sell order.

**Marketplace Participant:** A member of an exchange, a user of a quotation and trade reporting system, or a subscriber of an ATS (as defined in section 1.1 of Regulation 21-101).

**Market Pegged Order:** An order that is priced and re-priced as necessary to equal, or to be higher or lower than a reference bid, offer, or mid-point between a bid and an offer.

**Mid-Point Match:** an execution mechanism that derives the price from the mid-point of the NBBO.

**National Best Bid and Offer or NBBO:** In respect of a particular security, the best bid and offer of a standard trading unit across all transparent marketplaces not inclusive of Special Terms Orders

**Post-trade Transparency:** Refers to the ability of the public to see information about the price and volume of a trade after it has been executed. Information includes the volume, symbol, price, and time of the order.

**Pre-trade Transparency:** Refers to the ability of the public to see information about orders posted on a marketplace. Information includes the volume, symbol, price and time of the order.

**Price Discovery:** The process of determination of market prices through the interactions of buyers and sellers.

**Reserve Order (Iceberg Order):** An order that displays only a portion of its total volume at a price at which the participant is willing to trade. When the visible portion of the order is executed, an additional visible order is

automatically generated by the trading system of the marketplace drawing from the total size and decreasing the amount of the reserve.

**Smart Order Router:** A technological tool that scans multiple marketplaces for the best-displayed price and then routes orders to that marketplace for execution.

**Special Terms Order:** An order that is less than a standard trading unit, or is subject to a condition other than price or being settled on the third business day following the trade unless specified by the marketplace.

**Upstairs Market:** Where large blocks of shares are either worked by dealers who try to cross them with other client orders on an agency basis, or with inventory orders using their liability capital on a proprietary basis. These orders are usually entirely or partially withheld from the public marketplaces while being worked.