



Canadian Foundation for  
Advancement of Investor Rights  
Fondation canadienne pour l'avancement  
des droits des investisseurs

May 13, 2019

The Secretary  
Ontario Securities Commission  
20 Queen Street West  
22nd Floor  
Toronto, Ontario M5H 3S8  
[comments@osc.gov.on.ca](mailto:comments@osc.gov.on.ca)

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

**Re: Joint CSA/IIROC Consultation Paper on Internalization in the Canadian Equity Market**

---

1. FAIR Canada is pleased to offer comments on the joint CSA/IIROC consultation paper 23-406 on internalization within the Canadian equity market (the "Paper"). We commend the CSA and IIROC for examining the issue of internalization of order flow and its impact on retail investors in particular. As the Paper notes, internalization has long been an issue in equity markets because of its implications for market quality and efficiency, and for fair treatment of investors. FAIR Canada agrees with the observations at section 4.5 of the Paper, *"The retail investor is inextricably linked to any discussion about internalization... the focus of recent concerns is predominantly in relation to the orders of retail investors."*
2. **Fairness has been of particular concern where conflicts of interest arise between investment dealers' interests and their clients' interests.** Several types of conflicts arise, but the most significant conflicts are created when dealers trading for their own inventory accounts fill their client orders as principal. Dealers have an obligation acting as agents to obtain the best available price for client orders, but when they trade as principal their own interest is in buying at lower prices (if a client is selling) and selling at higher prices (if a client is buying). Those conflicts were largely addressed through strict rules on exposure of orders to the open market and the prices at which dealers can fill their own clients' orders. **Before those rules were adopted, clients were not being well served by many dealers that engaged in principal trading. That is a good illustration of why effective regulation of internalization of order flow is necessary.**
3. **FAIR Canada strongly advocates that the CSA and IIROC should strive to maintain and enhance the fairness and efficiency of equity markets and the competitiveness of**

**Canadian markets.** Efficient markets best serve the interests of investors generally. More broadly, efficient capital markets best serve the interests of all stakeholders, including issuers of securities seeking to raise capital in the most cost-effective manner, and the interests of the securities industry itself. Further, efficient markets that are well-regulated produce the fairest outcomes for all users of the market.

4. **Canadian capital markets will only remain competitive if the maximum level of efficiency is attained in our markets.** Canada is next door to the largest, most liquid and deepest capital markets in the world, markets that are easily accessible by Canadian issuers and investors at low cost. Sustaining competitive and effective Canadian capital markets is vital to our economy, as well as all participants and stakeholders in the market itself. **We cannot afford to permit market practices that serve the narrower interests of particular marketplaces, dealers or big players at the expense of the overall efficiency of Canadian markets.**
5. **The underlying principle of any organized market is to centralize or pool buyers' and sellers' activity to facilitate transactions (providing liquidity) and so they can obtain the best available price.** The efficiency of the pricing mechanism depends on how effectively buying and selling interest is centralized or pooled. An efficient pricing mechanism means the buyers and sellers can see the best prices that others are willing to trade at, and gauge the level of supply or demand at given prices. A market that provides efficient "price discovery" for interested buyers and sellers, and efficient pricing for trades, is a market that can best fulfill the attributes of an ideal market that the Paper describes. It is a market that provides transparency of prices, supply and demand. Transparency in markets has long been recognized as a significant benefit of central, public markets.
6. The Paper effectively asks about regulatory policy on internalization: **Should the wider interests of fostering fair and efficient markets prevail over the narrower interests of individual dealers and orders? FAIR Canada believes the answer is obviously yes,** for the reasons stated above. Clearly internalization of order flow means that fewer orders will be exposed to open, public markets. That would reduce the efficiency of price discovery and the pricing mechanism, and the visibility of supply and demand. **More internalization would lead to a market that is not only less efficient, but less fair and transparent.**
7. For the above reasons, FAIR Canada endorses the CSA's 2014 statement that, *"Retail orders are an important part of the Canadian market ecosystem, and the CSA continue to support the existing rule framework, which emphasizes the importance of these orders to the quality of the Canadian equity market, including the price discovery process"*.
8. **FAIR Canada submits that the important question is, should any more internalization of order flow be permitted in Canadian markets? FAIR Canada believes the answer is no.** What benefits would be provided to the markets and investors generally if more internalization was permitted? What would the costs be in terms of the efficiency and competitiveness of Canadian public markets? Canadian market regulation, as reflected in

securities regulators', Exchanges' and SRO rules, has long provided for compromises on the issue of internalization. Market regulations already permit a reasonable degree of internalization, both on-market (priority of orders for cross trades, subject to rules on client-principal trading) and off-market (arranged crosses, for example). Both intentional and unintentional crosses are expressly allowed and provided for, if certain conditions are met. **While not perfect or optimal for trading retail orders (to use the word in the CSA's question 13), arguably a better compromise on this issue has been reached in Canada than in the US.** The Canadian rules have accommodated the launch of many competing marketplaces, while largely maintaining the core principles of efficient markets: trade execution on a public market, price priority and exposure of orders to the best available market. This remains true even with the advent of high frequency trading (HFT) and dark markets.

9. **This regulatory approach is to be commended. It provides the benefits of competition among marketplaces and permits innovation in markets, while maintaining clear minimum standards of market integrity, fairness and efficiency. Those minimum standards are vital to ensuring fairness for retail investors' orders.** As the Paper explains, the execution of retail orders was an important element in the development of the regulatory framework for market structure (page 17). FAIR Canada supports continuation of that regulatory approach.
  
10. **Innovations in the markets have been achieved at the cost of some loss in the value of time priority, client priority and potential interference in crosses, but the evidence appears to be that those costs have not been significant.**<sup>1</sup> Question 13 in the Paper asks if the existing rule framework provides for optimal execution outcomes for retail orders. We do not think it ensures "optimal outcomes" – for example, see FAIR Canada's comments on IIROC's proposed rules and guidance on best execution in 2016.<sup>2</sup> Those changes to Rule 3300, effective in 2018, eliminated the requirement for dealers to provide clients with best execution of orders in favour of requiring dealers to establish "policies and procedures that are reasonably designed to achieve best execution", a clearly lower standard. In IIROC's Guidance on Best Execution, IIROC states that dealers "may not be able to achieve best execution for every single order it executes on behalf of a client". See our recommendation #4 concerning to this issue at the end of this letter.

---

<sup>1</sup> According to Figures 1 and 2 in Appendix A of the Paper, the percentage of trades executed as unintentional and intentional crosses increased marginally during the period 2016-02 through 2018-08. The percentage of volume and value crossed unintentionally increased slightly to 12.75% and 13.4% respectively. The percentage of volume and value crossed intentionally declined slightly to 8.87% and 11.67%.

Part 2 of Appendix A shows that the number of trades, volume and value executed through broker preferencing was about the same at the beginning and end of the period covered. The same is true for the percentage of trades, volume and value, except for a slight increase in the percentage of client-to-client trades executed in that manner.

<sup>2</sup> <https://faircanada.ca/submissions/fair-canada-comments-proposed-rule-guidance-best-execution/>

11. However, optimal outcomes may not be achievable in a market structure system that allows for competing marketplaces with different order types and trading priority rules. The current system is designed to achieve several significant policy objectives that reflect the needs and interests of different stakeholders, and the rules need to balance the need to meet objectives that to some degree are competing. We believe that the rule framework does provide for fair outcomes for retail orders, while also meeting other objectives.
12. Trading and order management technology has enabled the introduction of competing marketplaces while maintaining compliance with core regulatory principles by routing orders to, and splitting them among, markets with the best available prices and sizes, in split-seconds. This system enables the effective routing orders and discovery of prices on a consolidated basis, providing markets with liquidity and access to the best price and efficient executions. In theory, a centralized limit order book (CLOB) that applies strict time priority for client orders could produce a more efficient market and better outcomes for retail investors, but the costs of imposing a monopolistic market model would outweigh any additional benefits that might be obtained. It would be neither practical nor beneficial to turn the clock back in such a manner.
13. **It is difficult to identify practical ways to reduce the current level of internalization while retaining the benefits of competition among marketplaces, maintaining service levels for different types of clients, and allowing for innovation in market services.** It would also be difficult to require large, integrated firms to share more of their advantages of scale with other market participants. That might have unintended consequences that could ultimately impair market quality and efficiency.
14. **FAIR Canada submits that the rules and regulators' surveillance and compliance programs should continue to aim to ensure that conflicts of interest do not affect the quality of execution of clients' orders when a dealer is acting as principal.** In paragraph 2 we commented on the conflicts of interest that arise when a dealer intentionally fills its client orders by making a principal trade (i.e. for its own inventory account). We note that the Paper's data sample shows over 75% of intentional cross trades were client-inventory trades, compared to only 17% of unintentional cross trades. However, this data appears to mainly reflect the amount of block or large-sized volume and value executed in the upstairs institutional market, rather than crosses between retail orders and dealers' inventory accounts.<sup>3</sup> Nevertheless, this issue bears continued monitoring by regulators.
15. **FAIR Canada agrees that any trading service that aims to systemically pool and match orders should be a regulated market recognized by the regulators that complies with Canadian marketplace regulations, including UMIR.** If a large firm wants to increase their ability to internalize orders, they have the option to create and register alternative trading systems (ATs) with the regulators, or even to develop new securities exchanges in

---

<sup>3</sup> Table 1 of Appendix A shows that in period 5 only 0.11% of all trades were executed as intentional crosses, but those trades accounted for 11.67% of total value.

collaboration with others. Neither dealers nor marketplaces should be permitted to develop systems that facilitate internalization of order flow that are not subject to the minimum standards reflected in equity market regulations.

## Recommendations

**1. Regulators should continue to ensure that the rules and dealers' internal trading policies and procedures ensure that retail clients' orders are filled at the best possible price, particularly when a dealer fills its own clients' orders acting as principal.**

**2. Regulators should continue to ensure that the rules and dealers' internal trading policies and procedures ensure that retail clients' limit orders that are not immediately tradeable in the market are exposed on public, regulated marketplaces, except where best execution of an order would not be achieved by exposing the full order.**

**3. IIROC's UMIR rules on dealers' obligations to supervise trading operations should continue to ensure that its members have supervisory procedures in place to ensure that they comply with the rules and policies on best execution of orders, exposure of orders to marketplaces, internalization of order flow, and client-principal trading.** Also, dealers' internal compliance monitoring programs should be required to effectively monitor their compliance with such rules and policies. Dealers' supervisory procedures and internal compliance monitoring programs, as well as the results of their compliance monitoring, should be documented and available for review by regulators.

**4. IIROC market surveillance and trade desk compliance examinations should effectively monitor dealers' compliance with rules and procedures on best execution of orders, exposure of orders to marketplaces, internalization of order flow, and client-principal trading. A summary of the results of IIROC's compliance monitoring in these areas should be released to the public on a periodic basis.** The results should include IIROC's assessment of the level of compliance, and if concerns arise, its plans to address such concerns. Public reporting of results will assist in efforts to prevent the level of internalization from increasing over current levels.

On this point, we note that IIROC's annual compliance priorities report published in January 2019<sup>4</sup>, which summarized compliance findings from 2018, listed best execution as one of four issues highlighted under trading conduct compliance. The report stated:

### 2.2 Best Execution

We introduced changes to best execution requirements on January 2, 2018. We will focus our reviews on the efforts undertaken by dealers to address the changes in the requirements.

Our areas of focus include:

---

<sup>4</sup> IIROC Notice 19-0008

- documented and implemented policies and procedures that consider the factors and elements that contribute to the best execution of client orders
- content and disclosure of best execution policies
- governance around best execution decisions
- training conducted by the dealer, including that training is provided to all employees who are involved in the best execution process.

The fact that IROC highlighted best execution as a significant issue based on findings from its 2018 compliance reviews speaks for itself. We noted that the listed “areas of focus” do not include any actual review or assessment of the degree to which dealers are actually obtaining best execution for clients. The reviews will focus on dealers’ approaches to the issue, namely their policies and procedures, rather than the results they achieve for clients. In our view, IROC’s approach is inadequate because it examines policies instead of results, so fails to assess how well clients’ interests are actually being served. **We recommend that, at a minimum, dealers be required to carry out compliance monitoring of the degree to which they obtain best execution for clients (see recommendation #3 above) and that IROC review and assess the results of such monitoring when performing its compliance examinations.**

**5. The CSA and IROC should continue to periodically monitor data on the amount of internalization of orders in equity markets, and publish highlights of such monitoring.** The purpose of ongoing monitoring would be to enable regulators to assess, on a continuing basis, whether the level of internalization may become a greater concern. The purpose of publishing highlights of the data would be to inform investors, securities dealers and marketplaces about the issue and potential implications for market quality.

We thank you for the opportunity to provide our comments and views in this submission. We would be pleased to discuss this letter with you at your convenience. Feel free to contact Ermanno Pascutto at 416-256-6693 / [ermanno.pascutto@faircanada.ca](mailto:ermanno.pascutto@faircanada.ca).

Sincerely,



Ermanno Pascutto  
Executive Director, FAIR Canada

FAIR Canada is a national, charitable organization dedicated to putting investors first. As a voice for Canadian investors, FAIR Canada is committed to advocating for stronger investor protections in securities regulation. Visit [www.faircanada.ca](http://www.faircanada.ca) for more information.