TMX Industry Roundtable on Internalization in Canada's Equity Markets
Summary of Roundtable Event

Date held: Wednesday, January 31st, 2018
Location: TMX Gallery – 130 King Street West, Toronto
Attendees: See Appendix A

Roundtable Objective

The objective of the Roundtable was to promote open discussion and debate on internalization in Canada's equity markets, and to provide industry stakeholders with an opportunity to share their views and perspectives on internalization in order to foster a broader understanding of the key drivers, benefits and risks.

Roundtable Format

A total of 15 presenters, representing a range of stakeholders and trading interests including bank-owned and independent dealers, buy-side and proprietary trading interests, and academia, were allocated approximately 10 minutes each to present their views and perspectives. Attendees were allowed to ask clarification questions, as time permitted.

After the conclusion of the presentations, a roundtable discussion session of approximately 90 minutes in duration was held, during which all in attendance were permitted to participate.

Summary of Roundtable Themes and Observations

The following reflects our view of the key themes, comments, takeaways, and suggestions from the Roundtable as we heard and understood them. Although this summary is not intended to capture all comments and views made during the event, we have made an effort to highlight those areas that produced the most dialogue, were key points made by presenters, and/or were commonly highlighted by attendees.

a) *Key themes and takeaways*

- Internalization resulting from traditional upstairs market activities, including client facilitation undertaken in conjunction with those activities, does not raise concerns that are not already sufficiently addressed by regulation. Further consideration of these practices is likely not warranted at this time.

- Unintentional cross rates, a proxy for on-market internalization, have generally increased since the emergence of the current multiple marketplace environment. The most recent observed upward trend appears to have commenced during the summer of 2017.

- The primary reasons put forward to explain the most recent increases included the following:
  - changes in broker practices that maximize opportunities to match against resting same-broker orders, including those that leverage marketplace broker preferencing allocation logic;[1] and
  - an increase in market activity and volume from retail investors that is increasing the likelihood that these will be 'broker preferenced' against resting same-broker orders for dealers with a sizable retail client base.

- Regulation has defined the role of retail order flow in Canadian market structure. Trade-offs are inherent in certain rules, such as the UMIR order exposure rule, which result in higher levels of retail order participation on public markets. The active participation of 'on-exchange' retail order flow promotes liquidity and price discovery for the benefit of the broader market – in this sense, retail order flow may be viewed as a public good.

  This comes at the expense of higher execution costs for those same retail orders relative to what they could achieve via the types of retail execution mechanisms available in other jurisdictions (e.g., U.S. wholesaling models). Active participation of retail order flow can also promote higher levels of intermediation seeking to capture the value of non-directional retail order flow.

- The ability to capture the value of retail order flow was suggested to be one of the core drivers for changes in broker practices. Coupled with recent marketplace offerings that appear primarily designed to segment retail orders, these trends serve as evidence of the inherent value of this order flow. Such practices and mechanisms may be challenging the principles inherent in Canada's market structure.

  Another primary driver noted is the desire to mitigate the effect of 'unnecessary intermediation' on client orders that could have otherwise matched against each other, including any negative effect on execution quality and trade costs.

- To the extent that the upward trend in unintentional cross rates is believed to be a result of deliberate changes in broker practices, some concern was expressed as to the potential impact on competition, market quality and price discovery if the upward trend continues.

- It may be assumed that brokers will continue to seek ways to increase the efficiency with which they are able to effect matches between their own orders.

- Questions were raised as to the appropriateness and fairness of potential broker practices that seek to match proprietary orders against incoming client orders without the risk of exposing the proprietary order to the broader market. It was suggested this would arise if a broker were to leverage knowledge of incoming client orders and associated latency differentials to generate contra-side proprietary orders that are sent and booked on a marketplace ahead of its clients' orders so that broker preferencing could facilitate the match.

[1] Most visible equity marketplaces in Canada offer Price/Broker/Time priority, or some variant of this, which results in priority for attributed resting orders from the same broker over other resting orders with an earlier timestamp.

- Clarity from regulators as to what practices are (and are not) acceptable is needed to ensure a level playing field and to provide confidence that any observed increases in the unintentional cross rates of one or more brokers arises from compliant practices.

- An outright prohibition on broker preferencing was not broadly supported, and it was suggested such action should only be premised on analysis demonstrating evidence of harm. A pilot to study the impact of eliminating broker preferencing for a subset of securities was suggested as a means of gathering that evidence, although questions were raised about the value of these types of pilots in general. Adjustments to broker preferencing mechanisms were also proposed to address certain concerns and to maintain broker preferencing at reasonable levels.

b) Role of broker preferencing

The role of broker preferencing was a common consideration for presenters when discussing internalization. Broker preferencing was identified as a key facilitator for on-market internalization.

- Information provided by TMX to presenters prior to the Roundtable and reflected in certain presentations indicated that broker preferencing rose from approximately 8.5% of combined continuous traded volume on TSX & TSXV for the first 8 months of 2017 to between 10% - 12% by late December 2017 / early January 2018. The increase on TSX/TSXV was largely driven by broker preferenced trades between client orders, with approximately 70% of broker preferenced traded volume being 'client-to-client'. (Data for broker preferencing rates on other marketplaces is not available to TMX as this information is not typically contained in public trade reporting.)

- The primary cited benefits of broker preferencing included increased execution quality and lower market impact and trade costs arising from reduced intermediation for matched client orders, and in particular for larger client orders. Other benefits cited include a reduced need to introduce mechanisms existing in other jurisdictions that can facilitate similar outcomes, such as dealer-sponsored dark pools and wholesaling arrangements.

- The primary costs and concerns identified related to the potential for broker preferencing to increase adverse selection costs for non-broker preferenced resting orders, resulting in reduced incentives for investors to contribute to price discovery with their posted orders, leading to a subsequent deterioration in market quality. Concerns were also raised regarding the impact of broker preferencing on the competitiveness of smaller firms who have less breadth and diversity of trading interests (whether client or proprietary) relative to larger integrated firms, with which to take advantage of broker preferencing.

- It was suggested that broker preferencing was intended to allow dealers a limited ability to mitigate / control execution costs arising from requirements such as the order exposure rules, particularly for retail orders. There is an open question as to the point at which the level of broker preferencing would exceed reasonable levels, imposing more harm than good.

- While there was a lack of broad support for an outright prohibition on broker preferencing, a few presenters made the following suggestions to address concerns and to maintain broker preferencing at reasonable levels:
  - Provide priority to 'natural investor' orders ahead of broker preferencing to minimize incentives for the use of broker preferencing by prop desks and intermediary clients.
  - Charge fees, rather than provide rebates, for passive orders that jump the queue to reflect the fact that an economic benefit has been conferred on the queue jumping order.
  - Require that an order must rest for a minimum time before broker preferencing can be applied to ensure that it has been exposed to some degree of risk and has had the opportunity to contribute to price discovery before receiving the benefit of queue priority.

c) Other mechanisms that could be considered

- Presenters put forward a number of other suggestions intended to help decrease the incentives or effectiveness driving current practices that could facilitate or exacerbate on-market internalization. These included:
  - Adjustments to UMIR 'large order' thresholds to ensure that dealer facilitation of client orders via broker preferencing or other means is limited to truly large orders.
  - Regulatory allowances to permit the creation of marketplace models that explicitly segment retail orders, subject to access being provided to all providers of passive liquidity on fair and reasonable terms, and subject to mechanisms that would ensure that volumes executed in these mechanisms are kept at reasonable levels.
  - Optimization of minimum tick increments to increase the opportunity for competition between orders based on price and to reduce the utility of queue priority mechanisms.
  - Increased regulatory oversight of dealer routing or order management models that are designed to leverage broker preferencing to match its own orders.
  - Restrictions on broker practices that might involve proprietary orders taking advantage of latency differentials in reaction to incoming client orders.
  - Requirements for public disclosure of internalized trades.
  - Application (or clarification of the applicability) of regulation across dealer verticals as though the verticals were one unit where routing decisions have been centralized (i.e., where institutional, retail, and proprietary market making routing is managed collectively).

- It was suggested that additional analysis and study by regulators might be warranted. This could include a measurement of the extent of internalization and its impacts.

- The suggestion was also made for measurable outcomes to be identified before changes are made by regulators that affect market structure. These should define what outcomes will constitute success or failure for the changes.

APPENDIX A
List of attendees

Presenters & Guests

Firm	*Presenter*	*Guest Name*
BMO Capital Markets	Rizwan Awan	Tammy Jurca
CIBC	Heather Killian	John Pryde
Citadel	Mark Wilkinson	David Archer
Independent Trading Group	Thomas Kalafatis	Dave Houlding
ITG	Doug Clark	Earl Cummings
NBF	Patrick McEntyre	Alain Katchouni
OMERS	Rob Gouley	Brent Robertson
Raymond James	Mark Armstrong	Ross Davidson
Scotia Capital	Evan Young	Alex Perel
TD Securities	David Panko	Peter Haynes
Tower Research	Josh Burch	William Bregenzer
True North Vantage	Daniel Schlaepfer	Hugo Kruyne
University of Toronto	Andreas Park	
Virtu Financial	Tara Muller	
Wantfolio Group	Ian Bandeen	

Observers

Firm / Organization / Association	*Name*
AMF	Dominique Martin
ASC	Sasha Cekerevac
BCSC	Bruce Sinclair
OSC	Kent Bailey
OSC	Susan Greenglass
OSC	Tracey Stern
IIROC	Kevin McCoy
IIROC	Alex Taylor
MX Regulatory Division	Julie Rochette
Ontario Ministry of Finance	Amelia Nedovich
CSTA Trading Issues Committee	Kelly Reynolds
FAIR Canada	Frank Allen / Marian Passmore
Aequitas NEO Exchange	Cindy Petlock
CSE	Pina De Santis
ICX	Osman Awan
Liquidnet	Peter Coffey
MATCHNow	Bryan Blake
Montreal Exchange	Gladys Karam
Nasdaq Canada	Dan Kessous
Omega Securities	Sean Debotte
TMX	Jonathan Sylvestre

Moderator

Firm	*Name*
TMX	Kevin Sampson

Event Support

Firm	*Name*
TMX	Jeff Foster
TMX	Carina Kwan