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May 31st, 2019

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BY EMAIL : Comments@osc.gov.on.ca ; kmccoy@iiroc.ca; Consultation-en-cours@lautorite.qc.ca

RE: **Joint CSA/IIROC Consultation Paper 23-406 Internalization within the Canadian Equity Market,** (“Internalization Study”) published on March 12th, 2019.

National Bank Financial Inc. ("NBF") appreciates the opportunity to comment on the following Proposed Pilot. We support the CSA’s stated mission to provide a securities regulatory system that protects investors from unfair, improper or fraudulent practices and fosters fair, efficient, and vibrant capital markets.

NBF is part of the diverse National Bank Financial Group (“NBFG”) which: (i) manufactures mutual funds, owns proprietary distribution channels and supplies services to third party distributors; (ii) operates a discount brokerage firm; and (iii) is an IIROC-regulated investment dealer across Canada. We take great interest in initiatives contained in the Comment Paper and their potential impact on investors, the mutual fund industry, the investment industry and financial intermediaries.

Worth underlining here, in the NBF business description, is that we are one of Canada’s leading market makers in both ETF’s and common equities but also an integrated broker-dealer offering equity & ETF research, sales, and trading services to Canadian investors of all sizes including NBF’s retail & wealth management clientele. As such, we believe our perspective in market structure topics like this one to be holistic and balanced between these very different stakeholders.

Accordingly, our intention is to share our concerns regarding the Internalization Study. We trust that our comments will be considered during the review process and will provide a productive contribution to the outcome.

Internalization is a complex topic, involving many different stakeholders and a corresponding number of viewpoints. We applaud the CSA for taking the time to craft such a comprehensive consultation paper. The questions posed within it make for a well-structured, logically progressive discussion. We will do our best to answer where we can, in order, and as succinctly as possible in hopes of easing the burden on those CSA members tasked with parsing all the replies.

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After much consideration and internal discussion, our position on this topic is that, in the broadest sense, internalization of order flow is not a problem a priori. Transacting both sides of a trade is one of the primary goals of a broker-dealer in just about any asset class; it is an existential goal of the brokerage function.

Where internalization has begun to pose problems, at least in the current Canadian regulatory framework, is where *systematic* internalization begins to be developed. We believe that this encroaches on the function of a marketplace and as such runs counter to the prevailing rules of *fair access.* Further, when looking at the health of capital markets with the broadest possible lens, we feel that maintaining a *diversity* of participants to be a crucial feature for both near term liquidity and longer-term capital formation. Explicit segmentation of flow with a view to internalizing it directly undermines this attribute, and, we feel, harms the long-term health of the markets.

CSA Internalization Questions

Question 1: How do you define internalization?

In the broadest sense, internalization is any case where a single broker dealer represents both sides of an order. In NBF's opinion, internalization is one of the primary goals in any transactionally oriented brokerage model. From residential real estate brokers to car dealers to packages of loans, all types of brokers strive to earn commissions from both the buy & sell legs as well as lower transaction costs paid out to intermediaries.

NBF believes listed securities trading is no different, the economics of the business model drive participants to seek internalization.

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.

These are reasonable attributes to consider in evaluation of a market's health. We would underline #5, Fairness, as being a key to -the consultation paper and NBF's response. It is one of the more difficult attributes to evaluate, certainly quantitatively, however is likely the most important attribute for the long term health of a market, particularly for perception from external parties.

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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 can enhance liquidity & immediacy.

Internalization is unrelated to transparency (in Canada where trades must be printed)

In the extreme, internalization could be considered harmful to price discovery. Further, as the opportunity to internalize flow is greater in larger, integrated broker-dealers, it may challenge the perceived fairness in the markets, a key attribute to integrity.

An additional attribute NBF would submit for consideration on the health of a market is the **diversity** of participants within that market. Investors with different constraints, horizons, and investment strategies are more likely to have natural trading interest, resulting in more available trading liquidity, necessary for a robust, healthy market. NBF often discusses the fact that a marketplace with only deep-value investors likely can't achieve any transactions. They need growth investors to whom they can eventually sell their positions. This attribute relates to Liquidity; but it is measurable and valuable in its own right.

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

The balancing of common good vs the individual best execution is the principal conundrum in the context of internalization.

We believe broker-dealers enjoy benefits from internalization, for the reasons discussed at the outset: maximizing revenue, minimizing cost, and improved control over the fairness of the transaction. More importantly, in most cases, an internalized transaction provides better outcomes for both sides of a trade in a transaction. Liquidity is matched, impact is minimized, and pricing is fair as the dealer meets its best execution obligations to both sides.

NBF believes that while best execution is the main priority for order routing, it will be difficult to make the case that broker-dealers must curtail or even desist from this practice.

Introducing additional *societal* considerations to trading practices would be required should regulators seek to limit the increasing pace of internalization. Additional criteria could be considered for routing practices that would require the dealer to consider whether its effects will be contributing to the health of our marketplace or not. However, this would be exceedingly difficult to implement, monitor, and enforce.

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

Broker preferencing has been a key feature of Canadian market since it graduated from the floor to become fully electronic over 20 years ago. It was implemented with a view to mimicking the common practice in floor trading of matching an incoming ticket with the floor traders own held orders before showing to the rest of the floor. There are aspects of settlement risk that are mitigated by it as well.

Canadian trading rules (under UMIR 6.4 and 6.3) require that all trades be printed on a public trading venue and that all orders under a certain size be immediately exposed. The broker-preferencing feature has served as a trade-off, allowing broker-dealers to fulfil their own orders even while also exposing them, fostering the health of our transparency-focused regime.

Naturally, the drawback is that broker-preferencing favours larger, diversified broker dealers. Many interpret this to mean that it disadvantages Canada's smaller, boutique dealers. It has also contributed to an unusually vibrant *local*-dealer oriented industry. One is pressed to find another developed equity market in the world that does not have global bulge dealers numbered among the top participants. NBF believes that while broker preferencing may favour the larger Canadian dealers, it has served the Canadian markets well.

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

The benefits accrue more to dealers with diversified business lines and types of trading flow than simply to larger dealers. Large foreign dealers typically do not enjoy high rates of preferenced matching as they typically only route institutional flow directly. Dealers that have high matching rates are the ones that have strong wealth management & self-directed retail operations along with institutional &/or market making.

Diverse flow is more likely to match up than like flow.

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

The impacts would largely be the same between liquid and illiquid buckets, but possibly felt more severely in the illiquid bucket where concerns about liquidity availability are already high

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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?

Yes. It is already our understanding that this is the case. Systematic order matching is the basic definition of an electronic marketplace. This is a key part of the marketplace definition regulation and NBF sees no benefit to changing such a fundamental part of the Canadian Marketplace structure.

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?

Segmentation is a major concern in the context of the internalization discussion. NBF believes that systematic segmentation of any specific category of orders will undermine the diversity of flow within the marketplace, rendering it less liquid and, ultimately, less competitive. Whether dealers systematically segment and internalize the flow or marketplaces facilitate the mechanism with a combination of pricing and speedbumps, the net result is the same and runs counter to what NBF considers is the fundamental purpose of the fair access rule.

While effective segmentation by marketplaces has been allowed, via the accumulation of various order features over time, systematic internalization by dealers is not permitted. The lines between dealers and marketplaces is already quickly becoming blurred. It is a concern if these two different stakeholder groups enjoy different treatment in the context of internalization, particularly where the practice of segmentation will simply seek out the more lenient route.

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?

Yes. Retail orders are already well optimized, and it will only get better for this order flow in an increasingly segmented & systematically-internalized future. Pricing schemes on the inverted markets and marketplace-provided guaranteed execution functions like the MGF and GEF have allowed retail trading operations to find better liquidity at the touch than they would if they were not segmented, all while lower their overall trading costs. As segmentation techniques & practices get better, so too will the price improvements, rebates, and liquidity availability.

This is the key aspect that makes the internalization discussion so difficult. Under the best execution regime, absent of regulatory guidance to the contrary, retail order handlers are obligated to continue to improve execution outcomes for their customers regardless of how these practices may impact the broader markets' overall health.

Question 14: Should the CSA and IIROC consider changes to the rule framework to address considerations related to orders from retail investors? If yes, please provide your views on the specific considerations that could be addressed and proposed solutions.

As we mentioned, introducing a *societal good* aspect to the quality order handling would help to limit the continued pursuit of potentially unhealthy internalization practices. For example, is a dealer contributing to the liquidity eco-system in addition to pursuing best execution for its clients? However, this would be a significant change in the best-execution regime. And, as mentioned, it would be very difficult to implement, monitor, and enforce. There is precedent in Canada for such principals-based solutions and NBF would support any effort to issue guidance toward these goals.

It would be more practical for the regulators to issue some specific guidance to how they would like to see dealers handle the conflict between seeking best execution and ensuring the ongoing health of the Canadian liquidity complex.

Most simply, an immediately helpful and actionable solution to start with would be increasing the hurdle rate for the standard order exposure size. NBF suggests $250,000 order size and 250 board lots.

Conclusion

NBF appreciates the opportunity to comment on this important topic. There are no easy answers here, but the steps the CSA is taking to advance the discussion are good ones. We look forward to the next steps in this journey toward stronger, fairer, and more durable Canadian capital markets.

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