



December 22, 2009

British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Securities Commission
Manitoba Securities Commission
Ontario Securities Commission
New Brunswick Securities Commission
Securities Office, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Registrar of Securities, Northwest Territories
Registrar of Securities, Nunavut
Registrar of Securities, Yukon Territory

c/o John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
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Toronto, Ontario M5H 3S8

-and-

Madame Anne Marie Beaudoin
Directrice du secrétariat
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, Tour de la Bourse
Montréal (Québec) H4Z 1G3

-and-

Mr. James Twiss
Investment Industry Regulatory Organization of Canada
Suite 1600
121 King Street West
Toronto, Ontario
M5H 3T9

Dear Sirs and Madams:

Re: Response to Joint Canadian Securities Administrators'/Investment Industry
Regulatory Organization of Canada – Consultation Paper 23-404
Dark Pools, Dark Orders, and Other Developments in Market Structure in Canada

The Investment Counsel Association of Canada (“ICAC”), through its Industry, Regulation and Tax Committee, is pleased to have the opportunity to submit the following comments regarding Consultation Paper 23-404 – Dark Pools, Dark Orders, and Other Developments in Market Structure in Canada.

As background, the Investment Counsel Association of Canada (“ICAC”) represents investment management firms registered to do business in Canada as portfolio managers. In addition to this primary registration, some firms will be dually registered as exempt market dealers or other registration categories but generally 70% of their income is derived from portfolio manager registration to be members of the ICAC. Our 120 + members are from across Canada and are comprised of both large and small firms managing both institutional and private client portfolios. The ICAC was established in 1952 and manages in excess of \$700B assets (excludes mutual funds assets). Our mission is to advocate the highest standards of unbiased portfolio management in the interest of the investors served by Members. Member firms are in the business of managing investments for clients in keeping with each client’s needs, objectives and risk tolerances.

The ICAC wishes to comment on the joint CSA/IIROC discussion paper. To begin, we would like to express our support and appreciation for your efforts in seeking industry input into policy formation and rule-making in this area. This discussion is timely and necessary. We have noted with interest the developments in the U.S., including the SEC’s recently released proposals on Dark Pools (Regulation of Non-Public Trading Interest, Exchange Act Rel. No. 60997, November 13, 2009). The timing of these regulatory initiatives and the similarity of the issues that have been raised serve to highlight the very high degree of integration of the North American and global equity markets. While the Canadian marketplace has distinctive features that are unique to it, obviously we cannot be out of sync with the global markets.

Our high level concerns and comments can be summarized as follows:

- **Dark Pools serve an important function in the marketplace** - ICAC believes that there is, and has always been, a need and a role in the marketplace for hidden (i.e. non-displayed) liquidity. With effective and efficient regulation, Dark Pools support the objective of best execution for investors
- **Fairness demands a level playing field** - We believe there should be a level playing field in obtaining access to Dark Pools and Dark Orders and thus we do not advocate minimum volume requirements
- **Concern with IOIs** – For a number of reasons, we are not supportive of Dark Pools being able to send Indications of Interest (IOIs)
- **Partial visibility creates opportunities for abuse** – In our view, orders should be either dark (not displayed) or visible (publicly displayed to all). Degrees of visibility or selective visibility is more difficult to regulate, invites gaming of the system and does not necessarily result in better price discovery or liquidity.
- **High Frequency Trading represents risks to the system and requires regulation**- We believe the biggest risk today and one that regulators should prioritize is High Frequency Trading. We also have a concern that there is not

presently a level playing field for High Frequency Traders who are not required to do pre-trade compliance. This issue must be addressed. The SEC is also looking at regulation in this area and we recommend Canada align its regulation as much as possible with SEC direction.

Below, we respond to the specific questions raised in the discussion paper.

Questions Relating to Dark Pools:

Question 1: While trading on Dark Pools has not been extensive in Canada, please provide your views on the actual and/or potential impact of Dark Pools on:

a) Order size

- We believe the use of Dark Pools will increase the average order size. Currently the proliferation of algorithmic trading strategies has been eroding the average order size. As a result, traders are reluctant to show larger trades since they are unlikely to find a match for their size while giving up market information. In a Dark Pool which is truly dark, we believe that traders will be more willing to enter large orders since there would be no market impact from the unexecuted portion.

b) Price discovery

- Dark Pools will have a smaller impact on price discovery than does the upstairs market. In the case of an upstairs market a market participant can be excluded from a trade even if they are willing to pay a superior price. If a market participant does not generally deal with the dealer printing the trade, there is no time price priority. For large trades, Dark Pools do not detract from price discovery to the same extent as does the upstairs market and provide an efficient way to trade without incurring the market impact of trading in the visible markets.

c) Liquidity

- In our view, Dark Pools contribute positively to liquidity. If larger institutional investors can enter orders without fear of information leakage, then the hidden liquidity that exists on the desks and blotters of buy-side traders, or in their order management systems, is made available. If the trader can assume no market impact, he or she may be more willing to buy an illiquid security because he or she is confident that the size or simply the existence of the order will not have an effect on the price. On the other hand, if the Dark Pools are to become partially transparent prior to the execution of the trade, then this hidden liquidity would dry up because traders do not want to show their hands.

d) Market Fragmentation

- We do not view “market fragmentation” as a major problem in Canada. To the contrary, we believe that the historical centralization of equity trading in Canada on a single marketplace has had a net negative impact on order size, price discovery and liquidity. We believe that the movement away from a single, centralized environment to multiple marketplaces has been positive for investors and has led to decreased trading fees, more liquidity and innovation.

e) Trading Strategy

- Dark Pools are another tool at a trader's disposal, and this has been a very positive development for traders and their clients. It is useful for traders to be able to work an order either through an algorithmic strategy or a traditional broker while also representing the order in a Dark Pool. In our view, reliance solely on a traditional broker would have a significant negative impact on the price received for the trade.

f) Client Instructions

- Clients, particularly institutional clients, are well aware of the multiple marketplaces available to traders and are increasingly asking traders what venues they have available to them (for example through SORs) and can use. It can be a competitive advantage for a broker to have access to multiple markets in attracting and retaining new clients.

In your view, what will be the potential impact if the market share of Dark Pools in Canada increase significantly?

We believe the volume of trading through Dark Pools will increase significantly thereby attracting foreign investors. Indeed, this is already occurring, as the attractiveness of Canadian commodities and energy investments, together with a strong Canadian currency, has made itself felt globally. Global investors have in the past viewed Canadian securities and markets as too illiquid. Increased interest among global investors should increase the market share of Dark Pools while at the same time increasing the size of the market.

Question 2: Please provide your views on whether there should be a minimum size requirement for orders entered on Dark Pools?

We do not support a minimum size requirement. A minimum would result in shutting out the smaller, retail traders. This is not consistent with providing open, fair access to all. While setting a minimum order size may not materially harm the institutional client looking to cross blocks, it may increase the trading costs for small orders or larger orders divided into a number of smaller pieces. In a Dark Pool, orders are crossed at the current mid market price. If a small order has a limit equal to the offer price it will pass though the Dark Pool unexecuted. If it is entered as a market order it will trade on the bid side in the visible market. In the Dark Pool, it will be crossed at the current mid market price thereby improving the price for the small order and providing additional liquidity for the larger order.

Question 3: Please provide your views on whether Dark Pools should be permitted to send IOIs? If so, what information should be permitted to be included?

Question 4: Please provide your views whether or not Dark Pools should be permitted to select which destinations are able to receive IOIs? In your view should the ability to select which destinations receive IOI's be offered to subscribers?

Question 5: In your view, when does an IOI provide sufficient information to require it to be treated like an order that should be subject to pre-trade transparency requirements?

Question 6: In your view what kind of transparency about the practice of sending IOIs should be made by Dark Pools to their subscribers?

With respect to above questions 3, 4, 5 and 6, we do not think that Dark Pools should be permitted to send IOIs. The rationale for and value of a Dark Pool is that it allows participants to seek liquidity without impacting the price.

When Dark Pools send out IOIs, they undermine their very reason for being. The Dark Pools send out IOIs in an attempt to attract more flow. However, in doing so, they are giving away the very information that the Dark Pool subscriber is most concerned to protect. There is real, tangible value in the content of the order itself (i.e. the information that the order contains), and that value should be protected and accrue to the benefit of the market participant whose order it is, unless and until the market participant chooses to show it on a visible market. Also, when IOIs are sent, it in effect creates a two-tier market, with some participants having access to orders or to market information that is not available to everyone.

Question 7: Should Dark Pools be required to provide full or partial transparency of their orders if a threshold of trading activity is reached?

Please see response to Question 8 above. Any form of pre-trade transparency obviates the rationale for and value of Dark Pools.

Question 8: What are your views on the fairness of broker-preferencing?

There are pros and cons to broker-preferencing. Without preferencing, the upstairs market would cease to function. Despite the recent decline in the upstairs market, they still serve an important role in crossing large blocks. Broker-preferencing can also be useful for Dark Pools but can result in unfair fills, since price and time priority need not be respected.

Question 9: Are there other issues that should be considered in connection with Dark Pools?

We have no comment on this question.

Questions relating to Dark Orders

Question 10: Please comment on the actual and/or potential impact, if any, of Dark Orders on:

- a) Price discovery
- b) Liquidity
- c) Clients' execution instructions
- d) Trading strategy?

Please see our responses above, with respect to the Dark Pools generally.

Question 11: Please comment on the effect, if any, of the interaction of Dark Orders with visible limit orders on fairness and price discovery.

In our view, the existence of Dark Pools alongside visible limit orders on traditional markets is similar to the interlisting of securities on multiple exchanges. A careful trader should be monitoring both, if possible, in order to discharge the obligation to seek best execution on behalf of clients. This process is made easier through the use of smart order routers. It is also important for traders to monitor the Dark Pools together with the upstairs market.

Question 12: Should there be a minimum size requirement for certain Dark Orders? If yes, please explain?

We do not support a minimum order size. Please see our response to Question 2, above.

Question 13: Should a transparent marketplace allow fully-hidden orders to post at prices inside the prevailing spread (or should at least a portion of the order be required to be exposed thereby narrowing the spread)?

The transparent markets should not permit dark orders to post at prices inside the prevailing spread. In the dark markets, there should be full fill or the order dies.

Question 14: Should marketplaces be required to provide priority to visible orders over Dark Orders at the same price?

We believe that visible orders should enjoy priority over Dark Orders at the same price.

Question 15: Are there other issues that should be considered in connection with Dark Orders?

We have no comment on this question.

Questions Relating to Market Pegged Orders:

Question 16: Please comment on the actual or potential impact if any, of market pegged orders on:

a) Price discovery

In a truly Dark Pool, market pegged orders should have no impact on price discovery.

b) Fairness

From the point of view of fairness, pegged orders not as fair. They are able to take advantage of the visible orders (free ride), without making a contribution.

Question 17: Although this paper has not specifically addressed pegged orders that execute at the mid point of the NBBO, in your view, should market pegged orders be allowed to execute at prices unavailable to transparent orders (e.g. at a price between the bid and the ask when the spread is a single trading increment)?

Among our members, there were mixed opinions on this issue. There are pros and cons of allowing market pegged orders to be able to execute at prices unavailable to transparent orders. On the one hand, there is the opportunity for price improvement, no matter how small. However, there is the counter argument that allowing market pegged orders to execute at prices that are not available to the lit market is unfair, and does not provide the right incentives.

Question 18: Although this paper has not specifically addressed pegged orders that are fully-hidden, in your view are there any issues that arise due to fully-hidden market pegged orders?

We have no comment on this question.

Question 19: Are there other issues that should be considered with regard to market pegged orders?

We have no comment on this question.

Questions relating to SORs:

Question 20: What is your view of a marketplace SOR taking into consideration hidden liquidity posted on that marketplace when making routing decisions? Is it appropriate? Should the information be required to be provided to other participants? Should a marketplace's SOR be allowed to take into account hidden liquidity only after all visible liquidity at the same price on all marketplaces is executed against?

It should be possible to go into Dark Pool on the way to the visible market if an order is large enough to satisfy in Dark Pool.

Question 21: Is the practice of a SOR taking into account hidden liquidity posted on a marketplace an example of internalization of order flow? What are the similarities and differences with a dealer internalizing order flow?

We have no comment on this question.

Question 22: What are your views on internalization generally?

We have no comment on this question.

Question 23: What is your view on "databasing"?

We see nothing wrong with "databasing". It is simply a reflection of the industry automating processes that were once manual or took place informally.

Question 24: Please comment on whether there are there other issues that should be considered in connection to SOR's using hidden liquidity in routing decisions?

We have no comment on this question.

Other questions:

Question 25: Are there any other issues not discussed in this paper that should be considered for discussion at the roundtable that will be convened after the publication of this paper?

“High frequency trading” is an issue that requires attention by regulators. “High frequency trading” is a type of automated trading strategy with a short time horizon (usually seconds or minutes). Generally, these types of strategies get in and out of positions multiple times during the day but usually end up flat at the end of the day.

When our Association discussed this issue, there was some mixed opinion on whether “high frequency trading” raises issues of unfair advantage, impact on market liquidity and pre-trade compliance requirements, however there was a consensus at a high level that more regulation and control is needed in this area.

It is our understanding that there has been some discussion at the SEC regarding this issue. Accordingly, we would recommend that the CSA conduct some research in this area to identify issues with the current environment and ultimately align as much as possible regulatory direction in Canada with that of the SEC.

Question 26: In what way if any, do you believe that the combined potential impact of these developments represents risk to the market?

As discussed in question 25, there is systematic risk with high frequency trading.

We would be pleased to participate in a future roundtable on this issue. If you have any questions or concerns regarding our submission, please do not hesitate to contact Katie Walmsley at (416) 504-7018.

Yours truly;

INVESTMENT COUNSEL ASSOCIATION OF CANADA

Katie Walmsley
President, ICAC

Mark Pratt
Chair, Industry, Regulation & Tax Committee
Senior Legal Counsel, Mackenzie

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