13.2.3 Notice of Approval – Alpha Exchange Inc. – Changes to Intraspread

ALPHA EXCHANGE INC.

CHANGES TO INTRASPREAD™

NOTICE OF APPROVAL

On October 5, 2012, amendments to the Alpha Exchange Trading Policies were approved to reflect changes proposed by Alpha Exchange Inc. (Alpha) to the functionality of IntraSread™. The amendments include:

- Removing Dark orders that provide price improvement of 10% over the NBBO;
- Introducing Dark orders that can trade at the NBBO with:
  - SDL orders with volume over 50 standard trading units or value greater than $100,000, after any visible and reserve volume on Alpha at the same price level has been exhausted, and
  - All other SDL orders after any visible and reserve volume on Alpha at the same price level has been exhausted, but only when no visible volume is available on other markets at the same price.
- Allow SDL orders to trade with eligible Dark orders as well as with lit orders booked in the Alpha CLOB, while not trading through better priced orders on other markets.

A notice requesting comment on the proposed amendments was published in the Commission's Bulletin on July 26, 2012. The Commission received three comment letters in response to the notice. A summary of the comments received is published at Appendix A to this notice.

In addition to the amendments described above and as a result of issues raised during the regulatory review process, Alpha will also be making changes to remove the information from private feeds that indicates to the passive participant whether the order in the lit book executed against an SDL order.

Alpha will be implementing the amendments on October 15, 2012.

ALPHA EXCHANGE INC.

SUMMARY OF COMMENTS AND RESPONSES TO JULY 26, 2012 PROPOSAL ON ALPHA INTRASPREAD™ FACILITY

Background

The Ontario Securities Commission (OSC) published on July 26, 2012 Alpha Exchange (Alpha)'s notice regarding its proposed amendments to the Alpha IntraSpread™ Facility, in accordance with recent regulatory changes.[1]

Comment Process and Current Status

The OSC and Alpha received 3 comment letters, 2 from dealers[2] and 1 from an industry association[3].

Alpha would like to thank all commenters for their submissions. The summary that follows will summarize the issues and Alpha's responses. **The responses to the comments reflects the views of Alpha and do not necessarily reflect the views of the Ontario Securities Commission (OSC) or of the Investment Industry Regulatory Organization of Canada (IIROC)**.

Alpha's Proposal

Description of the proposed changes

Alpha is proposing to amend the IntraSpread™ functionality as follows:

- Remove Dark orders that provide price improvement of 10% over the NBBO.
- Introduce Dark orders that can trade with
  - o SDL™ orders with volume over 50 board lots or value greater than $100,000 (Large SDL™ orders), after any visible and reserve volume on Alpha at the same price level has been exhausted, and
  - o All other SDL™ orders (Small SDL™ orders) after any visible and reserve volume on Alpha at the same price level has been exhausted, but only when no visible volume is available on other markets at the same price.
- Allow SDL™ orders to trade with eligible Dark orders as well as with lit orders booked in the Alpha CLOB, while not trading through better priced orders on other markets.

Rationale and relevant supporting analysis

The proposed changes are being made in order to bring IntraSpread™ functionality into compliance with UMIR provisions respecting dark liquidity effective October 15, 2012. In addition, the changes are designed to maximize opportunities for price improvement and increased trade size for active SDL™ orders. SDL™ orders will now also trade against visible liquidity in the Alpha CLOB, increasing the pool of liquidity available for SDL™ order matching.

Summary of Comments and Responses regarding the Alpha IntraSpread™ facility proposed on July 26, 2012:

General Comments

There was one comment in support of the proposed changes to IntraSpread™; that it will have the beneficial effect of streamlining order handling and improving execution rates for SDL™ orders.[4]

There was also a comment expressing dissatisfaction with IntraSpread™ because it limits SDL™ orders (active orders) to retail customers.[5] Alpha developed the original model of IntraSpread™ as a result of market developments (including the maker-taker model) which over time began to penalize retail flow from both a cost and execution quality perspective. We believe that

1 See http://www.iiroc.ca/Documents/2012/2bfd5dea-85ca-4fca-9eae-cb30b474e7c5_en.pdf

2 ITG Canada Corp. and RBC Dominion Securities Inc.

3 CSTA Inc., an industry association

4 CSTA

5 ITG

markets should develop new solutions in response to changes in market structure and have to be able to take into account different client needs. Moreover, we have addressed concerns regarding the limitation by allowing dark to dark order execution.

The main issue identified in the three comment letters was alleged information leakage.

Information Leakage

Introduction

With the proposed IntraSpread™ implementation, SDL™ orders may trade with resting Dark and Lit orders, while passive Lit orders may interact with both incoming Lit and SDL™ orders. These are different trade categories with likely different active/passive fees, which introduces indeterminacy to the participant with respect to what fee or rebate will be applied when the order executes.

In order to address this risk and to allow the participant to keep track of fees in real time, and consistent with previous implementations, the proposed implementation introduces an additional trade type to identify the SDL™/Lit trade on the Alpha execution messages. This will allow participants to distinguish Lit/ SDL™ executions from other trade types and accurately determine net fees in real-time.

Comments

The main focus of the comments was on the potential for information leakage due to this new trade type, in that it provides the passive participant an immediate means to distinguish between incoming SDL™ flow, which is exclusively from Retail participants, and non-SDL™ flow.

Underlying this concern was the assertion that non-SDL™ flow is certainly non-retail, and furthermore in all probability from Institutional participants, so that an execution marked as Lit/Lit is tantamount to directly identifying the counterparty as Institutional. Furthermore, it was asserted that an execution against an active Institutional order is indicative of imminent additional order flow in the same direction, amounting to information that can boost anticipation strategies to the passive participant's advantage, and to the detriment of the Institutional investor.

One commenter questioned the need for real-time passive rebate information, while another took the position that such information, if provided, should not provide participants with any special advantage over the counterparty.

Suggested alternatives included identifying all SDL™ trades on the public record of trades and providing end-of-day rebate information to participants. It was also suggested that participants should be able to use rebate approximations in their trading strategies.

Alpha Response

Alpha believes that identification of a counterparty as non-SDL™ is not an indicator of Institutional order flow and as such does not confer a straightforward advantage to the participant on the passive side of such trades.

- Assumption that a non-SDL™ order is not retail is incorrect. Not all active retail orders are routed to IntraSpread as SDL™ orders, and of those that are, only about 20% are filled in IntraSpread. The rest of the retail flow is routed to liquidity pools other than IntraSpread, including the Alpha CLOB. Our estimate is that today a lit order priced above a dollar and resting passively on Alpha has a 25% likelihood of trading against a retail order not marked as SDL™. Even if SDL fill rates increase with the new implementation, the likelihood of trading with a retail-order not marked as SDL™ remains high.

- Even if all active retail flow was to be executed as SDL™ in IntraSpread, that would not contribute to the ability to identify an Institutional counterparty. For securities priced over $1 (where IntraSpread activity is concentrated), retail flow represents less than 30% of the market. The rest of the flow is divided among different participants, including HFTs, proprietary traders and the buy-side. For liquid names, filtering out retail flow still leaves a good mix of directional and non-directional active strategies on the market and therefore cannot be used to boost anticipation/momentum strategies. For illiquid names where executing a large trade presents a challenge, there is limited retail presence so filtering it out would hardly reveal any information not already available on the public tape.

- Natural market forces will counteract any anticipation or momentum strategies feeding on SDL™ vs. non-SDL™ information, because these strategies become predictable in their own right (e.g. another proprietary strategy can start sending non-SDL™ orders to Alpha lit with the intention of misleading the passive participant trying to identify Institutional flow).

Alpha also believes that real-time fee information is critical in today's markets.

- With maker-taker fees at approximately 25% of the average spread, any real time net position monitoring and risk-management system must incorporate accurate fee information.
- A marketplace which is not providing sufficient information that is required to determine fees in real-time would contribute to an increase in overall risks associated with electronic trading.
- Alpha believes that marking every SDL™ trade as such on the public tape would not address the perceived problem of information leakage.

Miscellaneous Comments

Clarity of Communication

Comments

One commenter pointed out that the new SDL™/non-SDL™ trade attribute was not sufficiently prominent in the Alpha product sheet to ensure it received the proper attention.[6]

Alpha Response

Alpha does not believe that the additional tag values identifying the counterparty as non-SDL will have any impact on the market structure and therefore this change was not highlighted in the summary of changes or in the product sheet.

However, Alpha does believe in full transparency which is why a detailed product sheet with full business explanation, examples and technical information is always provided to the public at the time of filing.

The standard structure of an Alpha product sheet is to describe features in more qualitative terms at the beginning of the document, and group technical/implementation details in the latter part of the document. This is not meant to imply that the technical aspect of the facility represented in the product sheet is of lesser importance than its business features.

Development Burden on Participants

Comments

One commenter expressed concern that the new tags on the trades will require participants to rebuild their trading engines, which imposes an unreasonable demand on participant development in the context of other ongoing initiatives[7].

Alpha Response

The proposed changes were specifically designed to minimize impact on Members and Solution Vendors. There are no required changes for parties entering SDL™ orders. Dark liquidity providers are expected to cease use of 10% Dark orders and to incorporate 0% Dark orders in their trading strategies.

In addition, SDL™/Lit vs. Lit/Lit information is communicated on fill messages using an existing 'trade type' attribute. With this release, we are adding a single new trade type (SDL™/Lit) in addition to existing 7 trade types (auction, cross, odd-lot autoexec, lit/lit, SDL™/dark, dark/dark and cross interference). Clients not requiring real-time fee information do not need to process this tag and no rebuild is required.

Fees

Comment

One commenter provided comments on the fee structure of IntraSpread for trades that are executed between SDL order types and orders on Alpha's CLOB.[8]

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6 CSTA

7 ITG

8 RBC Dominion Securities

Alpha Response

No fee proposal was discussed or in any way included in the July 26, 2012 description and publication for comment. Changes to the fee schedule were only recently filed with the regulators on September 12, 2012 and should be processed in the ordinary course as set out in NI21-101 and the Rule Protocol.

Please contact Randee Pavalow at randee.pavalow@alpha-group.ca for any questions.