OSC STAFF NOTICE AND REQUEST FOR COMMENT REGARDING PROPOSED STRUCTURE OF TRADING FACILITIES FOR A NEW EXCHANGE PROPOSED TO BE ESTABLISHED BY AEQUITAS INNOVATIONS INC.

I. INTRODUCTION

This notice (Notice) is being published by OSC staff (Staff or we) in connection with a pre-filing[1] relating to a proposed new equities exchange to be established by Aequitas Innovations Inc. (Aequitas). Aequitas proposes to operate an exchange to trade securities of senior issuers listed on Aequitas[2] as well as securities listed on other recognized exchanges in Canada (Aequitas Proposal).[3] A summary of the relevant aspects of the proposed structure of Aequitas' trading facilities (Proposed Trading Structure), and Aequitas' rationale for that structure, is set out in a document prepared by Aequitas attached at Appendix A to this Notice.

As stated in the OSC Statement of Priorities for 2013-14: "Markets have experienced significant change and innovation in their structures over the past five years, largely due to advancements in technology and increased competition. It is an enduring objective of the OSC's work in this area that markets remain fair and participants have confidence in market quality and integrity, including order entry, execution and settlement processes." We also note that securities regulators, marketplaces, market participants and investors all have a common interest in sustaining robust and efficient capital markets. Innovation and competition is an important element in achieving that goal.

Staff strongly support innovation and competition in the Canadian capital markets. However, Staff will review any proposal filed with the OSC within the context of the principles and objectives of the current regulatory framework and more broadly, the OSC's statutory mandate. The Aequitas pre-filing is being reviewed using this approach, while taking into consideration that the regulatory framework may change as a result of ongoing regulatory initiatives.

In connection with the Aequitas pre-filing, we are publishing for a 45-day public comment period certain aspects of the Proposed Trading Structure. We are requesting comment on Aequitas' pre-filing because of the significance of certain issues raised by the Proposed Trading Structure in the context of the existing principles and objectives. This request for comment is intended to help further inform Staff and gather any new information and input from stakeholders, in advance of the filing by Aequitas of an application for recognition as an exchange (Exchange Application).[4] We are also publishing the Notice at this stage, and before

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[1] Generally, a "pre-filing" is a consultation with the regulator initiated before the filing of the application regarding the interpretation of securities requirements, or the application of securities requirements to a particular matter or transaction.
[2] The name of the proposed exchange to be established by Aequitas has not yet been determined. References to Aequitas in this document are either in reference to Aequitas Innovations Inc. or to the proposed exchange itself, as appropriate in the context used.
[3] The proposal at this time is that it will also trade securities listed on TSX and TSX Venture.
[4] At this point, Aequitas has not filed an application for recognition as an exchange.

receipt of the Exchange Application, to be as responsive, efficient and transparent as possible in light of the Aequitas Proposal.

The Aequitas Proposal includes elements other than the Proposed Trading Structure discussed in this Notice.[5] Those elements will be reviewed by staff and will be included in the publication of the Aequitas Exchange Application for comment, where appropriate, in due course.

The comment period for this Notice will end on September 27, 2013. Please refer to Part IV of this Notice for information on the means for providing comment.

II. THE EVOLUTION OF THE REGULATORY FRAMEWORK AND MARKET STRUCTURE FOR EQUITIES TRADING

It is important to set out the market structure context and the principles underlying the associated regulatory structure that has been established over the last number of years. These principles have been established within the context of the OSC's statutory mandate to provide protection to investors from unfair, improper or fraudulent practices, and to foster fair and efficient capital markets and confidence in capital markets.

In this section, we have outlined the principles and the relevant regulatory and other developments that we think are important for establishing context around the Proposed Trading Structure.

A. Regulatory developments

In the last number of years, there have been some significant regulatory developments that have impacted the evolution of the market structure. In our view, the key developments are the implementation of the framework for alternative trading system (ATS) regulation and the introduction of competition, the order protection requirements (OPR), and the rules respecting dark liquidity (Dark Rules).

1. Regulatory framework for marketplaces and the introduction of competition

In 2001, the Canadian Securities Administrators (CSA) established a framework to permit competition among traditional exchanges and other marketplaces, while ensuring that trading is fair and transparent. The regulatory objectives of National Instrument 21-101 *Marketplace Operation* (NI 21-101) and National Instrument 23-101 *Trading Rules* (NI 23-101) (collectively referred to as the Marketplace Rules) were to provide investors choices, to improve price discovery, to decrease execution costs, and to improve market integrity.

The original framework contemplated a regime where only exchanges were subject to fair access requirements and fragmentation was to be addressed through order and trade transparency requirements, a plan for data consolidation to enable access to quote data from all marketplaces,

[5] For example, it would include details regarding Aequitas' proposed governance structure and model for listings and issuer regulation, and the functionality of the Proposed Trading Structure.

and a plan for the inter-linkage of marketplaces so that all buyers and sellers of a security would have access to the best price for execution (market integration).[6]

After taking into consideration the views of an industry committee struck to examine data consolidation and market integration (the Industry Committee),[7] the CSA implemented the Industry Committee's recommendation to abandon the plan for market integration and instead focus on best execution and fair access requirements to achieve the same result.

The first step taken towards this objective was to extend the application of the fair access requirements from exchanges to ATSs.[8] The result was that both exchanges and ATSs were thereafter subject to requirements to not unreasonably prohibit condition or limit access to the services they offered. This change was intended to facilitate compliance with best execution requirements.

The best execution requirements at the time[9] focused on obtaining best price when acting as agent. Specifically, they required a dealer when acting as agent, to make reasonable efforts to ensure its client received the best execution price. At the same time, those requirements prohibited the dealer when acting as agent from executing a transaction on a marketplace if it could be filled at a better price on another marketplace or with another dealer. The CSA formally began its review of best execution in 2005[10] and introduced amendments to best execution requirements in 2007,[11] which were implemented in 2008.[12] These amendments changed the focus of best execution to an assessment of a number of factors, including price, certainty, speed of execution and the overall cost of the transaction.

[6] At a high level, the data consolidation plan envisioned the creation of a data consolidator that would consolidate and distribute order and trade information for securities traded on multiple marketplaces. The initial plan for market integration contemplated the creation of a market integrator that would effectively facilitate the routing of orders between marketplaces trading the same securities. The 2001 version of the Marketplace Rules contemplated market integration in two stages: the first stage requiring ATSs to establish an electronic connection to the "principal market" for each security traded on that marketplace before executing a trade in that security; and the second stage requiring all marketplaces to establish an electronic connection to a market integrator or, if there was no market integrator, to establish an electronic connection to each other. It was contemplated by the CSA at that time that if the industry achieved complete market integration voluntarily, it might not be necessary to create a market integrator.

[7] As expressed in the Report to the CSA Market Structure Committee from the Industry Committee on Data Consolidation and Market Integration, dated March 7, 2003 and published at (2003) 26 OSCB 4385.

[8] Proposed in July 2003 and published at (2003) 26 OSCB 4377. Approved in October 2003 (published at (2003) 26 OSCB 7147), and effective in January 2004.

[9] The best execution requirements are found both in the Marketplace Rules and in UMIR. We will focus on those in the Marketplace Rules.

[10] Concept Paper 23-402 – *Best Execution and Soft Dollar Arrangements* published on February 4, 2005 at (2005) 28 OSCB 1362.

[11] Published as part of the supplement to the OSC Bulletin titled *Trade-through Protection, Best Execution, Access to Marketplaces and the Consolidation of Data*, on April 2007 at (2007) 30 OSCB (Supp-3).

[12] Approved by the CSA in June 2008 and implemented on September 12, 2008. See *CSA Notice on Best Execution Amendments to National Instrument 21-101 Marketplace Operation and National Instrument 23-101 Trading Rules* published on June 20, 2008 at (2008) 31 OSCB 6303.

2. *The Order Protection Rule*

The CSA began its review of order protection or trade-through[13] in February 2005 with the issuance of a discussion paper.[14] The discussion paper led to the publication of a notice in April 2007 (April 2007 Notice), in which the CSA, jointly with Market Regulation Services Inc.,[15] reviewed developments in market structure and regulation in the US and Europe in the context of best execution and order protection. The CSA also reaffirmed that certain principles that had established the foundation for the Marketplace Rules remained relevant for the purposes of the continued development of the regulatory framework. Those principles reflect the values of: price discovery, liquidity, competition, innovation, market integrity and fairness. The CSA also noted through its consultations and review of academic and industry studies that most market participants believed that the ideal or preferred equity market structure included integrated marketplaces – i.e., to reduce the negative impact of multiple marketplaces trading the same securities, there should be access to information and access to orders.[16] Further, the CSA expressed that:

> *…there continues to be value in a market structure that promotes the interaction of orders, creates incentives to place transparent limit orders and allows participants to identify and execute against the best available limit orders. Market participants and commentators have described the ideal structure as one that brings together all types of participants in a transparent and efficient manner. Access by different types of marketplace participants requires that the rules are appropriately applied to all participants to promote fairness… Some reduction in transparency and competition among marketplaces based on factors other than prices does not, in our view, undermine the value of the integrated marketplaces.*[17]

In other words, the CSA confirmed the importance of transparency, access to limit orders, and of fair and appropriate application of rules and requirements to those accessing a marketplace. There was also an acknowledgement that there is some room for variation in the appropriate circumstances, which was primarily in reference to the different model for transparency and access to orders offered by dark markets.

OPR was subsequently finalized in November 2009 and implemented in February 2011. Order protection was described in the notice of approval[18] as a requirement that would "ensure that all immediately accessible, visible, better-priced limit orders are executed before inferior-priced limit orders and are not traded through".[19] OPR requires that marketplaces, and dealers when

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[13] Under NI 23-101, a trade-through occurs when an order is executed at a price that is lower than a "protected bid" (in simple terms, a displayed bid) or at a price that is higher than a "protected offer" (again, in simple terms, a displayed offer).

[14] Discussion Paper 23-403 *Market Structure Developments and Trade-Through Obligations* published on July 22, 2005 at (2005) 28 OSCB 6333.

[15] Market Regulation Services Inc. merged with the Investment Dealers Association of Canada in 2008 to form the Investment Industry Regulatory Organization of Canada (IIROC).

[16] Page 6 of the Joint Canadian Securities Administrators / Market Regulation Services Inc. Notice on Trade-Through Protection, Best Execution and Access to Marketplaces published at (2007) 30 OSCB (Supp-3).

[17] Ibid.

[18] Published at (2009) 32 OSCB 9403.

[19] While approved only in 2009, a form of order protection had always existed – OPR was an extension of the existing UMIR "best price" obligation to participants in the market other than dealers.

using directed-action orders, are subject to requirements to establish, maintain and ensure compliance with written policies and procedures that are reasonably designed to prevent trade-throughs.[20] It was described as an obligation owed by marketplace participants to the market as a whole and one that cannot be waived. The CSA noted that OPR was intended to instill confidence on the part of all types of investors so that they would contribute to price discovery by posting visible limit orders.

In the absence of OPR, there were concerns that investors, including retail investors, would perceive an un-level playing field if their orders were not being executed despite showing the best price. If this were to occur, it could lead to a loss of confidence in the fairness and integrity of the market, the subsequent removal of investors / liquidity from the market, and a decrease in the efficiency of the price discovery process. Critics of OPR, however, expressed a number of concerns, including the potential for increased costs and that it would lead to a lack of innovation and competition in Canada.

As part of the development of OPR, consideration was given to whether ATSs should be explicitly required to provide access to all groups of marketplace participants, and whether and how marketplaces would allow access to non-members / non-subscribers. Up until the April 2007 Notice, the CSA had been interpreting the ATS fair access requirements to allow an ATS to set access criteria that limit access to a specific type of marketplace participant (for example, only institutional subscribers) as long as it was not unreasonable or contrary to the public interest. In other words, in limited circumstances consistent with the principles and the mandate of the OSC, marketplaces were permitted to limit access and still comply with the fair access requirements. We note, however, that these circumstances were generally limited at that time to marketplaces that provided no pre-trade transparency,[21] and that the application of these principles was further refined with respect to visible markets as a result of the finalization of OPR.

In finalizing OPR, the CSA determined that to address the above-noted access issues it would enhance the fair access provisions by providing additional guidance regarding the meaning of fair access.[22] This included clarifying that fair access to the services of a marketplace applied more broadly than just access to the trading facilities, but applied in the context of access to all of its services, including services related to order entry, trading, execution, routing and data. More importantly, the added guidance also clarified that, for the purposes of complying with OPR, a marketplace should permit fair and efficient access to their participants, and to parties indirectly accessing the marketplace through the participant. Embedded in this approach and

[20] Under NI 23-101, a trade-through occurs when an order is executed at a price that is lower than a "protected bid" (in simple terms, a displayed bid) or at a price that is higher than a "protected offer" (again, in simple terms, a displayed offer).

[21] This interpretation as applied to equity marketplaces was primarily limited in application to the dark trading facilities BlockBook (operated at the time by Perimeter Markets) and Liquidnet. However, this interpretation had also been applied to Shorcan ATS, a manual block execution facility that traded TSX and TSXV-listed equity securities, displayed only the orders at the best bid and offer, and which only permitted dealers trading as principal to conduct trades on the system. Order information was only displayed to Shorcan ATS subscribers and not publicly.

[22] In the form of the addition to Companion Policy 21-101CP of subsections 7.1(2) and (3) with respect to recognized exchange access requirements, and subsections 8.1(2) and (3) with respect to ATS access requirements. The fair access requirements for exchanges and ATSs were later harmonized into one single provision regarding access, and so the similar guidance is currently reflected in subsections 7.1(2) and (3) of the current Companion Policy 21-101CP.

consistent with the idea of and rationale behind OPR is the notion that displayed orders at the best price should be accessible to all.

3. Dark Rules

Commencing in October 2009, the CSA together with IIROC published a series of joint papers that resulted in the implementation of the Dark Rules, which outline the regulatory approach to dark liquidity.[23] These rules require a resting dark order to provide meaningful price improvement to another order, define the "minimum price improvement" needed to be meaningful, and establish priority for visible orders over dark orders at the same price on the same marketplace.

In developing the regulatory framework for dark liquidity, the CSA and IIROC outlined some of the key characteristics against which any resulting changes to the Canadian market should be assessed – those being some of the same characteristics referred to by the CSA when developing both the Marketplace Rules and OPR: liquidity, transparency, price discovery, fairness, and integrity. How these characteristics were defined is set out at Appendix B to this Notice.

In arriving at the regulatory approach reflected in the Dark Rules, and in the context of these above-noted characteristics, the CSA and IIROC looked to balance the benefits of dark liquidity (including the minimization of market impact costs associated with the execution of large blocks in a visible book, the minimization of information leakage concerns, and the potential to obtain price improvement) against the potential risks – the primary risk being that if orders that would traditionally be sent to visible marketplaces were increasingly diverted to dark pools or entered as dark orders[24], there could be a negative impact on the price discovery process and to the liquidity available to those participants that are required to, or have elected to, display their orders on a visible market.

Ultimately, to protect the quality of the visible order book while acknowledging the benefits of using dark liquidity, the CSA and IIROC focused on encouraging the posting of visible orders and encouraging the exposure of liquidity to the widest variety of contra-side participants.

4. Summary of evolution of regulatory framework and underlying principles

In our view, any potential change to the existing framework necessitates consideration of the characteristics of an efficient and effective market in the context of the OSC's mandate. These characteristics include liquidity, transparency, price discovery, fairness, and integrity. In addition, the role of competition must also be considered.

The evolution of the regulatory framework for trading in equities has led to a clear delineation between the approach to visible liquidity, through which much of the price formation and

[23] This consisted of three joint papers being: (1) Joint CSA / IIROC Consultation Paper 23-404 *Dark Pools, Dark Orders, and Other Developments in Market Structure in Canada* published in October 2009 at (2009) 32 OSCB 7877; (2) Joint CSA / IIROC Position Paper 23-405 *Dark Liquidity in the Canadian Market* published in November 2010 at (2010) 33 OSCB 10764; and (3) Joint CSA / IIROC Staff Notice 23-311 *Regulatory Approach to Dark Liquidity in the Canadian Market* published in July 2011 at (2011) 34 OSCB 8219.
[24] In the November 2010 Position Paper referenced in footnote 23, a "dark pool" is defined as meaning a marketplace that offers no pre-trade transparency on any orders, while a "dark order" is defined as meaning an order on any marketplace which is entered with no pre-trade transparency.

discovery process occurs, and the approach to dark liquidity, for which price is generally determined by reference to the visible quotes.

Regulatory protections have tended to favour visible liquidity by encouraging the posting of visible orders and facilitating the exposure of liquidity to the widest variety of contra-side participants. This is evident from the stated objectives and implications of OPR, and the way that fair access requirements in the Marketplace Rules have been applied to visible markets as compared to dark markets. It is further evident from the objectives and design of the Dark Rules.

More specifically, the evolution of the regulatory framework for visible liquidity has effectively resulted in:

- the protection of all better-priced displayed orders to ensure that markets are perceived as being fair and having integrity, and to instill confidence on the part of all investors to post their orders and thereby contribute to price discovery and liquidity;
- an interpretation of fair access applicable to visible markets that does not generally contemplate discrimination by type or group of participants or inhibit access by anyone (all can access through a dealer); and
- the recognition that the protection of all better-priced displayed orders provided by OPR necessitates that the fair access requirements be applied to visible markets in a way that ensures access to those better priced displayed quotes.

Finally, we reiterate that the Marketplace Rules were conceived to foster competition, as long as the means of competition are consistent with the characteristics and principles of an efficient and effective market.

B. Other significant developments

In addition to the changes to the regulatory framework, there have been some other significant developments that have impacted the trading of equity securities in Canada.

1. Multiple marketplace environment

While the Marketplace Rules have been in place since 2001, it wasn't until 2007 that the current competitive environment began to more fully emerge. There are now six visible markets other than the listing exchanges trading TSX- and/or TSXV-listed equity securities.[25][26] In addition, there are currently four dark markets trading these same securities.[27] This has had the effect of reducing the market share of the listing exchanges and fragmenting order flows across various trading facilities.

The emergence of multiple marketplaces has also brought choice to participants and investors. Marketplaces have introduced different fee models, faster or innovative technology, and new

[25] There is also one ATS currently trading CNSX-listed securities.
[26] These six visible markets are: Pure trading (operated by CNSX Markets), Chi-X and CX2 (operated by Chi-X Canada ATS), Omega ATS (operated by Omega Securities), and the Alpha and TMX Select facilities (ultimately owned and operated by TMX Group). As noted in an earlier footnote, Shorcan ATS ceased trading in equities in May 2007 and so is not included in this count.
[27] Liquidnet, MATCH Now (operated by TriAct Canada Marketplace), IntraSpread (operated by Alpha Exchange), and ICX (operated by Instinet).

order types. Competition between dark markets has also included differentiation based on access criteria – for example, based on segmentation by type or category of subscriber or by type of order flow.[28]

2. Maker-taker pricing model

In 2005, TSX introduced a volume-based maker-taker fee model to incentivize the posting of liquidity. Under the maker-taker fee model, the liquidity providing side (the maker) of the trade receives a rebate while the liquidity taking side of the trade (the taker) pays a fee. While initially introduced by TSX on securities inter-listed on NASDAQ and AMEX, this model was extended in 2006 to trading in all TSX and TSX-V listed equity securities. Since then, it has generally formed the basis for trading fee models used by the competing visible equities markets in Canada for their continuous trading sessions. The other model used most often for continuous trading sessions is the "inverted" maker-taker model – where the liquidity taking side receives a rebate and the liquidity providing side pays a fee.

3. High frequency trading

The Canadian equity marketplace has experienced significant growth in high speed, low latency and technologically driven trading activity, transforming market dynamics across the industry. The IIROC report on Phase I and II of its study of high frequency trading (HFT)[29] points to the advent of decimalization, multiple marketplaces, increased competition among marketplaces, the globalization of trading and the advancement of trading technologies as all having helped to lay the groundwork for HFT. Using what it referred to as high order-to-trade ratio (HOT) trading as a study group, IIROC found that the HOT User ID's identified through its study represented: 11% of the User IDs active in the study period; 22% of share volume traded; 32% of dollar value traded; 42% of trades executed; and 94% of new and amended orders.

C. Issues with current market structure and regulatory framework

Market participants and investors have expressed a number of concerns regarding how the market structure for equities trading has evolved and the impact this has had on market quality and market integrity. Some of the common issues and concerns raised by market participants include:

- Maker-taker pricing and fragmentation of orders have led to increased levels of intermediation.
- Technology and speed advantages of HFT firms, together with competition amongst them for passive rebates, have created an un-level playing field and contributed to the "crowding out at the quote" of traditional investors (retail and institutional).
- The above contribute to increased trading fees for dealers, and in particular retail dealers, as it leads to these dealers being takers of liquidity (i.e., being active) more frequently

[28] Examples of this include Alpha IntraSpread where active flow is limited to "Retail Customers" as defined in IIROC Member Rules, and Liquidnet who has focused on institutional investors.
[29] The HOT Study - Phases I and II of IIROC's Study of High Frequency Trading Activity on Canadian Equity Marketplaces, issued on December 12, 2012 and available for download at: http://docs.iiroc.ca/DisplayDocument.aspx?DocumentID=C03DBB4490324C6B946E6F2BD6CF4E23&Language=en.

and paying the taker fees, and has also led to higher trading costs for clients whose trades are crossing the spread more often to get executed.

- There is a lack of options for dealers looking to decrease trading fees as the introduction of the Dark Rules affected the economics for liquidity providers within certain dark markets.
- There is a lack of meaningful competition amongst marketplaces to address cost issues of its participants.
- Increased intermediation has contributed to increased technology costs associated with higher message rates. Similarly, multiple marketplaces and the effects of competition have increased the complexity of trading and therefore increased the costs associated with managing that complexity.
- Traditional market makers are unable to compete and maintain a reasonable profit level from their market making activities and are leaving the market.
- Regulatory requirements such as OPR may have contributed to the complexities and inefficiencies noted above.

A number of these issues are also identified and elaborated on by Aequitas in connection with its rationale for developing the Proposed Trading Structure described in Appendix A to this Notice.

D. Current regulatory initiatives

As noted above, market participants and investors have raised a number of concerns and issues regarding how the market structure for equities trading has evolved and the perceived impact on market quality and market integrity. We have been considering these issues in the context of current regulatory initiatives.

One of those initiatives includes an examination of OPR. As outlined earlier, OPR was intended to address certain issues pertaining to investor confidence and efficiency of price discovery that can arise in an environment where multiple marketplaces are trading the same securities. As a result of how the market structure has evolved, questions arise as to whether the intended outcomes have been achieved and at what cost. That is, to what extent do the benefits of OPR, such as:

- efficiency gains from the virtual consolidation of fragmented marketplaces; and
- an increased investor perception of a level playing field resulting from their visible better-priced quotes trading ahead of other inferior-priced orders;

outweigh the potential costs of OPR including the inefficiencies that might arise:

- if market participants have become captive consumers of marketplace services in order to comply with OPR;
- if excess rents are being earned by marketplaces from captive consumers supporting an otherwise unsustainable level of competition; and
- if the presence of any level of otherwise unsustainable competition results in excessive complexities, costs and frictions for equities trading.

As a result of these questions, we will be undertaking an examination of market structure, with particular focus on OPR. As part of that review, we will also be continuing our work on data fees, as discussed in CSA Staff Consultation Paper 21-101 *Real-Time Market Data Fees*.[30] The level of rebates and trading fees, and the implications of these in the context of an OPR environment, will also be considered.

Concurrent with these initiatives, IIROC is continuing with Phase III of its HFT study that may help to identify whether there are in fact specific market quality or market integrity issues with high frequency trading that need to be addressed through new or amended regulation.

The outcomes of these initiatives could influence the structure and dynamics of trading in the equity markets, and thereby address in part a number of the issues raised with the current market structure.

III. THE AEQUITAS PROPOSAL

It is in the context of the evolution of the market and the issues raised above that Aequitas has come forward with its proposal. As indicated earlier, and consistent with our approach for all proposals, the Aequitas proposal will be reviewed within the context of the principles and objectives of the current regulatory framework and more broadly, the OSC's statutory mandate. In this section, we have summarized the key aspects of the Proposed Trading Structure (i) that have been identified by Aequitas as being critical to the success of its model, and (ii) regarding which we have identified issues as a result of our review and upon which are asking for public feedback.

Aequitas' proposed exchange will include distinct order books referred to by Aequitas as the "Dark", "Hybrid" and "Lit" books. In each of these books, Aequitas plans to facilitate trading in Aequitas-listed, TSX-listed and TSXV-listed securities. The order books will offer different features and functionalities intended to serve different trading objectives. The unique aspects of the Proposed Trading Structure that give rise to the issues identified in this Notice relate primarily to certain features of the Hybrid book and the proposed market making program. These aspects are summarized as follows:

<u>Hybrid book</u>

(i) Any party can post passive liquidity in Hybrid, but access to removing liquidity is restricted to orders that do not bear the short-marking exempt marker (SME marker).

(ii) Executions on Hybrid will only occur at or within the NBBO[31] established on other visible marketplaces (Away NBBO).

(iii) Aequitas will display and disseminate the aggregated volume of orders resting in the Hybrid Book on a price-by-price level for each price level at or within the Away

[30] Published on November 8, 2012 at (2012) 35 OSCB 10099.

[31] NBBO represents the 'National Best Bid and Offer' which means, in respect of a particular security, the best bid and offer of a standard trading unit across all transparent marketplaces excluding Special Terms Orders.

NBBO[32] and there will be no pre-trade transparency for bids less than, or offers greater than, the Away NBBO.

(iv) The priority of matching for passive liquidity is price, broker, market maker[33], and weighted size/time.

(v) Aequitas' general intent is to offer a "take-take" fee model for trading on Hybrid, with low fees and additional discounts on active fees for retail trading networks.[34]

Market making program

(i) DEA clients can act as market makers where sponsored by a registered investment dealer that is a member of the Aequitas exchange.

(ii) Symbols can be assigned for Aequitas-listed securities, as well as for securities listed on other Canadian exchanges.

(iii) Market makers will have some priority benefit[35] in all but the Lit book (but only with respect to their assigned symbols).

(iv) Market makers may be provided additional compensation for meeting performance standards, which may include preferential trading fees.

The issues associated with the key aspects of the Proposed Trading Structure are discussed below.

A. Segmentation of order flow

While all parties can post liquidity in Hybrid, all active liquidity taking orders marked with the SME marker (SME orders) [36] will be rejected (herein referred to as "segmentation of order flow"). This is intended to ensure that only retail and institutional client orders can be entered as active orders in Hybrid. It is also intended by Aequitas to restrict the ability of HFT firms to enter active orders for the purposes of pursuing what it has identified as being predatory trading strategies,[37] thereby

[32] For example, if the Away NBBO is $10.00 bid and $10.05 offered, and there were 2,000 shares in aggregate bid at $10.00 on Hybrid and 1,000 shares in aggregate bid at $10.01 on Hybrid, Hybrid would display each of these price levels and the aggregated volume at each such price level.

[33] Only for their assigned symbols.

[34] See page 10 of Aequitas position paper titled *Innovation for Fair Markets* available on the Aequitas website at: http://aequitasinnovations.com/wp-content/themes/discover/docs/Aequitas_Innovations_Position_Paper_240613.pdf

[35] Within each price level, market makers will have priority with respect to trading in their assigned symbols after broker, but before all others and regardless of any priority based on time.

[36] A "short-marking exempt order" under UMIR is defined as an order for the purchase or sale of a security from account that is:

(a) an arbitrage account;
(b) the account of a person with Marketplace Trading Obligations in respect of a security for which that person has obligations;
(c) a client, non-client or principal account:
  (i) for which order generation and entry is fully-automated, and
  (ii) which, in the ordinary course, does not have, at the end of each trading day, more than a nominal position, whether short or long, in a particular security; or
(d) a principal account that has acquired during a trading day a position in a particular security in a transaction with a client that is unwound during the balance of the trading day such that, in the ordinary course, the account does not have, at the end of each trading day, more than a nominal position, whether short or long, in a particular security.

[37] The trading strategies identified by Aequitas as being predatory are outlined in Appendix A to its document attached at Appendix A to this Notice.

encouraging the posting of passive liquidity by protecting all providers of liquidity against these strategies.

This segmentation of order flow in Hybrid raises a number of questions – specifically with respect to the principles underlying OPR and fair access requirements.

1. Segmentation of order flow in the context of the principles underlying OPR

As indicated, the displayed prices on Hybrid that are at or within the Away NBBO will not be accessible by all participants in the market. This could therefore lead to trade-throughs of the orders displayed on Hybrid by participants trading on other marketplaces. Specifically, a trade-through could occur when an active SME order that is restricted from accessing the best price shown on Hybrid is routed to marketplaces that display an inferior price.[38] A trade-through could also occur where the participant wants to trade more volume than is being shown on the away marketplace.[39] This raises a number of questions.

An underlying principle of OPR is that *all* visible orders will be accessible to *all* parties. This is key to having an effective order protection rule – without accessibility, investor confidence may be hampered because of the potential for confusion about why the best prices were not in fact executed. By showing the volumes at the NBBO or better but not providing access to all, Staff do not think that the proposal is consistent with this important principle.

While the proposed segmentation of order flow on Hybrid, together with its execution pricing mechanism, can result in trade-throughs of the orders residing in Hybrid, we recognize that these orders are more likely to represent the passive orders of HFT firms, institutional buy-side client orders (whether placed there itself through DEA, or by its dealer acting as agent), or dealer proprietary interests. It is not generally expected that these will represent retail client orders. The types of participants whose orders may be traded-through on Hybrid may be willing to post their passive orders without OPR protection in exchange for access to retail and institutional order flow, and the ability to be insulated from certain trading strategies referred to by Aequitas as being predatory in nature.

We note that the above refers to the possibility of a SME order trading-through the displayed orders on Hybrid when trading on an away marketplace. A question also arises as to whether those orders on Hybrid should be completely unprotected – i.e., whether non-SME orders that are able to access the best displayed prices on Hybrid should be required to do so.

Other implications of the inaccessible displayed best prices on Hybrid could include the possibility of an increase in the number of instances of locked and crossed markets. However, Aequitas has indicated that it intends for displayed prices on Hybrid to not be permitted to create

[38] For example, where the best bid in the Away NBBO is s $10.00 and Hybrid is showing a best bid of $10.01, an active SME sell market order will have no choice but to execute against the inferior bid of $10.00 on an away marketplace, trading through the best bid of $10.01 on Hybrid.

[39] For example, in the circumstances where Hybrid and one other marketplace are each displaying 500 shares at the best bid of $10.00, and an active SME sell market order seeks to execute 1,000 shares, it would execute against the 500 shares displayed at $10.00 on the away market and could simultaneously execute at the next price down on that market of $9.99 – resulting in a trade-through of the $10.00 bid displayed on Hybrid at the time that the active SME order was sent.

the appearance of a locked or crossed market with the Away NBBO (or internally on Hybrid), through some form of continued re-pricing of the displayed prices within Hybrid or by some other means.

Finally, the display of inaccessible best prices on Hybrid raise questions in the context of the application of the Dark Rules – specifically, questions arise as to which price reference (i.e., best price established on an away marketplace or on Hybrid) should be used for determining the execution price involving a dark order at which minimal price improvement requirements are met.[40]

Question 1: ***Should OPR apply to all visible markets and to all orders displayed on those markets, or are there circumstances where the application of OPR should be limited?***

Question 2: ***Should OPR apply to Hybrid? Should it continue to apply at least with respect to active non-SME orders that are not restricted from accessing the best-priced displayed orders on Hybrid?***

Question 3: ***If Hybrid is implemented as proposed, how should the best-priced displayed orders on Hybrid be treated for the purposes of consolidated display requirements, and why?***

Question 4: ***What should the appropriate reference price be for determining whether a dark order on any other market has provided minimum price improvement as required under the Dark Rules – the Away NBBO or the NBBO that includes a Hybrid best bid and/or Hybrid best offer? Does the answer to this question depend on whether or not OPR applies to Hybrid?***

2. Segmentation of order flow in the context of the principles underlying fair access

The evolution of the regulatory framework has led to an interpretation of the fair access requirements applicable to visible markets that does not generally contemplate differentiation of access by type or group of participant. This facilitates the exposure of liquidity to the widest variety of contra-side participants and supports efficiency in the price formation and discovery process. The application of fair access in this manner also promotes investor confidence in the fairness of the markets by ensuring that all participants are able to access displayed best prices. OPR as currently implemented also necessitates that fair access be applied in this way for visible markets to ensure that result.

Allowances have been made for dark markets to restrict types or groups of participants (e.g., restricting access to only institutional investors) and for restrictions on the types of order flow (e.g., restricting the active orders / liquidity takers to orders representing retail clients). These types of restrictions have been permitted as reasonable limits on access for a number of reasons, including that dark markets do not provide pre-trade transparency of prices, and therefore, OPR does not protect dark orders.

[40] For example, if the best bid on an away marketplace is $10.00, and a bid of $10.02 is displayed on Hybrid, and assuming the best offer displayed on any marketplaces is $10.04, questions could be raised as to whether minimal price improvement requirements have been met if a market sell order sent to the away marketplace in this example executed against a resting dark order at $10.01.

In the context of the different approaches taken with respect to fair access regarding the visible and dark markets, the focus of our analysis of fairness is on the segmentation of order flow proposed for Hybrid.

Hybrid is similar to a visible market in that it will provide transparency for orders that are at or within the prevailing Away NBBO, but proposes that access to those orders be limited in a manner previously only considered acceptable for dark markets. We recognize that the proposal for segmentation of order flow does allow any participant to provide liquidity in Hybrid. It also precludes participants whose orders must be marked as an SME order from accessing the passive liquidity. In doing so, it may restrict certain participants' abilities to fully participate in the visible markets and access the best displayed price. As a result, we question whether this proposed segmentation of order flow is consistent with how the fair access requirements should be applied for visible markets.

We also recognize that 'fairness' is a matter of both perception and perspective,[41] as well as a matter of judgment. Further, the wording of the fair access requirements contemplates the possibility that some form of restriction on access could be construed as being reasonable; however, to date, what has been considered reasonable for dark markets has not been applied to a visible market.

From the perspective of those who cannot access the displayed liquidity on Hybrid, we question whether it is fair for a marketplace to impose restrictions on access to orders displayed at the best prices. Further, we also question whether it is appropriate to implement that restriction based on the perceived benefit or harm of certain behaviours while at the same time restricting a broader range of activities and strategies that might provide benefit, or support beneficial activities. For example, SME orders may also represent orders from accounts used to conduct arbitrage, from market makers when trading in their assigned symbols, from a dealer's principal account that is used to obtain or unwind positions to facilitate a large transaction with a client, or even from an HFT firm conducting trading strategies that might not be categorized by Aequitas as being predatory in nature.

From the perspective of investors, however, the application of these restrictions might be considered to be fair if it shields them from negative behaviours or if it is viewed in the context of an investor's investment objectives, relative to the objectives of those using SME orders (e.g. profit-making activities). SME participants that provide liquidity within Hybrid might also view the restriction to be fair given they will also benefit from the protection being offered against perceived negative behaviours, despite themselves being subject to the same access restrictions in Hybrid with respect to their active liquidity removing orders.

Despite this, it is our view that from an overall market perspective, the primary question is whether the application of fair access requirements for visible markets should preclude the proposed segmentation of order flow.

Question 5: How should fair access requirements be applied with respect to access to visible marketplaces?

[41] Eric Kirzner, "Ideal Attributes of a Marketplace", June 22, 2006, Task Force to Modernize Securities Legislation in Canada, "Canada Steps Up", Volume 4 – "Maintaining a Competitive Capital Market in Canada", pg. 116.

Question 6: ***Should visible markets be fully accessible or, like dark pools, should access restrictions be permitted? Why? What are the criteria that should be used to determine if the differences in access are reasonable? What impact, if any, could restricting access to the best displayed price have on confidence and market integrity?***

Question 7: ***Are the access restrictions proposed for Hybrid consistent with the application of the fair access requirements?***

Question 8: ***Is the SME marker an appropriate proxy to identify the behaviours Aequitas seeks to restrict?***

B. Aequitas market making program

Aequitas has indicated that certain parts of its market making program are central to the success of its model. Below we have identified issues associated with those parts.

1. Market maker priority

Aequitas is proposing that market makers in its Lit book gain some level of priority in the matching algorithms in each of the Dark and Hybrid books. In each of these cases, a market maker's passive orders will have priority after same broker (broker preferencing), but before all others at the same price. A market maker will only gain this priority with respect to trading in its assigned symbols.

Market makers have often been provided with the benefit of having some level of priority or participation in orders relative to other investors. This has typically been provided as one of the offsets to the costs of having market making responsibilities. However, questions can arise regarding fairness and the possible impact on investor confidence if investors perceive that market makers' passive orders do not provide sufficient benefit to justify being rewarded with priority.[42] This question is particularly relevant in the context of the proposed market making program in that:

- a market maker is permitted full participation in the matching priority (but only for its assigned symbols); and
- its obligations for providing liquidity are proposed to only relate to its trading in the Lit book.

In addition, questions can also be raised as to whether these types of market maker benefits are appropriate for market making in issuances listed on another exchange (e.g., in the case of TSX-listed securities to be traded on Aequitas' order books).

Also, in the context of fairness and its impact on investor confidence, Staff note that Aequitas' proposal for market makers to receive priority in matching could negatively impact investor confidence if the likelihood of an investor achieving a fill on its passive order is diminished because it is too far down the line in terms of priority, behind both broker preferencing and

[42] Kirzner suggests that it may be fair for priority rules to give priority to orders based on their benefit to the market (pg. 117 of document referenced at footnote 41).

market makers. Priority for market makers might therefore contribute to an increased likelihood that natural investors will be crowded out at the quote.

Question 9: ***What, if any, is the impact on market quality and market integrity if market makers are provided matching priority (after broker preferencing)?***

Question 10: ***In light of the details of Aequitas' proposed market maker program, is it reasonable to provide the benefit of priority to a market maker in the Dark and Hybrid books when the market maker's corresponding obligation is limited to the Lit book? If not, should there be market making obligations in Aequitas' Dark or Hybrid books?***

Question 11: ***Should market making benefits accrue with respect to obligations for market making in non-Aequitas listed securities? If so, why and if not, why not?***

2. DEA clients as market makers

Aequitas has proposed that clients of its members could act as market makers (DEA client market makers). These DEA client market makers would be sponsored by registered investment dealers that are members of the Aequitas exchange (sponsoring dealer), and the sponsoring dealer would agree to be accountable for the actions of the DEA client market maker. A DEA client market maker is not expected to be a registrant in any jurisdiction in Canada, nor a member of the exchange or directly subject to IIROC rules (including UMIR)[43]. It is expected that these DEA client market makers could be HFT firms that are located in foreign jurisdictions.

The proposal for non-registered[44] DEA client market makers is not consistent with our expectations regarding regulatory oversight of market makers. Market makers are required by exchanges to take on certain obligations in exchange for certain benefits. They have traditionally played a broader role of assisting with the maintenance of a fair and orderly market and supporting market integrity by acting as a gatekeeper. As a result of these roles and responsibilities, and the benefits received in exchange, it has been expected that market makers for equity securities be registered with the securities regulatory authorities, directly regulated by IIROC for compliance with IIROC rules, and members of the exchange for the purposes of monitoring and regulating market making obligations. The oversight that results is, in our view, important to ensure that a market maker lives up to its obligations for which benefit is being provided, and that it does so within the rules and construct of the regulatory framework. We note that Aequitas is considering an additional requirement that DEA client market makers be a regulated entity subject to regulated oversight in a foreign jurisdiction – for example, a member of FINRA or registered with the SEC – and/or that the DEA client market maker be a designated market maker on an existing exchange. However, it is questionable how these are suitable proxies for IIROC membership in this regard, as the foreign regulator and / or other exchange may not have rules or compliance requirements applicable to its registrants / members when trading via intermediaries on foreign markets.

[43] The sponsoring dealer might not be responsible for any actual violation of rules (e.g., UMIR) by the DEA client market maker, but would be responsible for inadequate supervision and for an inadequate control environment that allowed for the rule violation by its client.
[44] That is, not registered in any jurisdiction in Canada, regardless of where domiciled.

There is also a question of fairness in that an un-level playing field could be created between DEA client market makers and registered investment dealers that also seek to become market makers. In particular, both types of market makers would receive the same benefits from Aequitas for performance of duties, but would be subject to different regulatory standards. There might also be additional benefits available to DEA client market makers that would not be available to registered investment dealers that are market makers – for example, a DEA client market maker would be able to take advantage of broker preferencing by establishing itself as a client at one or more dealers; it might also have benefits or protections under UMIR as a result of its status as "client" under those rules.

Question 12: ***Should DEA clients that are not subject to the direct regulatory authority of the securities regulatory authorities, IIROC and/or the exchange be permitted to act as market makers? Why or why not? How would the following facts affect your response: (i) the DEA client market maker must be sponsored by an IIROC member and (ii) the DEA client market maker must be a member of a self-regulatory organization such as FINRA or otherwise subject to appropriate regulatory oversight?***

Question 13: ***Will an un-level playing field be created between DEA client market makers and registered investment dealers that also seek to become market makers on Aequitas' proposed exchange? If so, what are the potential implications in terms of fairness or market integrity?***

C. Potential impact of Hybrid on market quality and market integrity

While the Proposed Trading Structure has been designed by Aequitas to provide an innovative and commercially-driven solution intended to address certain issues it has identified in the Canadian market, there is the potential that the design of Hybrid could have a broader impact on the rest of the market as a whole, for reasons similar to those that led to the development of the Dark Rules. Specifically, we question whether Hybrid may create risks to the efficiency of the price formation and price discovery process that takes place on the traditional visible markets, and implications on the liquidity available to those trading in those markets. These questions arise because of the incentives within Hybrid to provide liquidity and route active order flow, the types and level of interactions that might result from the incentives, and the level of contribution to price formation and discovery that might take place on Hybrid.

In our view, one of the primary incentives supporting the provision of liquidity within Hybrid will likely be the protection from certain trading strategies referred to by Aequitas as being predatory in nature, through the proposed segmentation of order flow. This is an incentive broadly available to all types of participants that choose to place their passive orders on Hybrid. However, we question whether the availability of certain other incentives might make it more likely that the accessible displayed orders on Hybrid will largely represent the orders of DEA client market makers and HFT firms. These other incentives include the potential for: (1) increased certainty of execution for market makers through the priority afforded to them; (2) increased certainty of execution for HFT firms that are DEA clients of dealers with significant active agency order flow through broker preferencing on Hybrid; and (3) the replication of some of the economics of dark markets that were lost when the Dark Rules were implemented, by allowing an opportunity for liquidity providers to execute at a lower risk of adverse selection as a result of the segmentation of order flow and at a price where no price improvement has been provided.[45]

In terms of active order flow to be routed by a dealer to Hybrid, one of the primary incentives in our view will likely be the low trading fees to be charged relative to the liquidity taking fees charged on other markets. Aequitas has indicated that it is also considering additional discounts to the active trading fees for retail trading networks.[46] We question whether these low relative fees and additional discounts might result in a higher tendency for the active order flow routed to Hybrid to represent retail client orders.

As a result of all of these incentives, there may be a risk that Hybrid will attract a significant amount of active order flow (which might be "uninformed" retail order flow) away from the price formation and price discovery mechanisms of the traditional visible markets. This may have the result of exposing the passive orders in those markets to a higher proportion of trading strategies that Hybrid is designed to avoid, or to a higher risk of adverse selection.[47]

To the extent the above-noted risks materialize, we question how this might affect investor confidence in the quality of the visible market as a whole, their continued willingness to post limit orders, and what the resulting potential impact might be on liquidity and the efficiency of the price formation and price discovery process. This is in addition to the potential impacts on investors' confidence in the integrity of the visible market discussed earlier in this Notice – for example, as a result of any perceived unfairness of priority for market makers, or confusion from an increased number of trade-throughs seen on the public tape.

Finally, while Hybrid will contribute to price formation and discovery through the display of orders at or within the Away NBBO, we question whether its contribution would be sufficient to offset any potential negative impacts outlined above (if realized). In our view, the extent of its potential contribution to price formation and discovery may be diminished if the types of order flow being displayed and brought together on Hybrid are not sufficiently varied (e.g., if there is a predominance of trades involving market makers and active retail client orders), and given its pricing mechanism is reliant on the prices displayed on other visible markets. Further, the fact that depth of volume and prices outside of the Away NBBO will not be displayed on Hybrid means that there may be less overall informational value from the displayed Hybrid orders in terms of price formation.

Question 14: How might Hybrid impact the quality and integrity of the visible market as a whole?

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[45] Based on Aequitas' current proposal for Hybrid, Hybrid passive orders would not need to provide price improvement to the NBBO because Hybrid would display orders (aggregate volume) and would therefore not fall under the definition of Dark Order.
[46] See page 10 of Aequitas' position paper titled *Innovation for Fair Markets* available on the Aequitas website at: http://aequitasinnovations.com/wp-content/themes/discover/docs/Aequitas_Innovations_Position_Paper_240613.pdf
[47] In this context, the risk of adverse selection arises where one party to a trade has more or better information than its counterparty, which allows the more informed party to profit at the expense of the other. In our view, most of the trading strategies referred to by Aequitas as being predatory in nature are not a form of adverse selection and so we have referred to the risks of increased exposure to those trading strategies referred to by Aequitas separate from any increased risk of adverse selection that might result.

Question 15: ***Please comment on whether the potential benefits of Hybrid for the marketplace participants in Hybrid outweigh any potential risks to the market as a whole? Please identify the relevant benefits and risks.***

D. Hybrid as a visible market

Aequitas brings forward its Proposed Trading Structure to address a number of issues that are identified above, but it does so in a way that raises questions for a number of fundamental principles underlying the current regulatory framework for visible and dark liquidity, most notably in relation to Hybrid. These questions, as described throughout this Notice, arise primarily because Hybrid shares certain properties of both lit and dark books. For example, by choosing to display accessible resting orders (whether on an aggregate basis or not), it is our view that Hybrid is a visible market.[48] However, Hybrid will not display all resting orders and will employ a pricing mechanism that is largely expected to be reference based. Further, Aequitas seeks to have the principles underlying OPR[49] and fair access be applied in a manner previously only applied to dark markets – i.e., by segmenting order flow within Hybrid. Additional questions have also been raised regarding the potential impact of Hybrid on market quality and market integrity that are similar to those that led to the development of the Dark Rules – including requirements for price improvement that Aequitas proposes would not apply to executions within Hybrid.

Consequently, if Hybrid proceeds in its current proposed form, it may necessitate deviating from a number of regulatory principles and objectives that have been fundamental to the development of the current regulatory framework for visible and dark markets.

Question 16: ***How should the principles of the current regulatory framework and any potential for changes to that framework impact the OSC's consideration of Hybrid? For example, should Hybrid go forward on a pilot basis and be re-evaluated based upon some criteria or threshold? What type of criteria or threshold might be appropriate to minimize potential negative impact?***

Question 17: ***Alternatively, should Hybrid be required to be modified to fit clearly within the established regulatory framework for either visible or dark liquidity? If so, how?***

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[48] By displaying orders in this manner, Aequitas would be subject to requirements under Part 7 of NI 21-101 to provide the displayed order information to the information processor, as required by the information processor.

[49] As those principles relate to trade-throughs.

IV. COMMENT PROCESS

We are seeking comment on the areas of the Proposed Trading Structure identified in this Notice, and are seeking specific comment where indicated by questions posed.

Comments should be in writing and submitted by Friday, September 27, 2013 to:

Market Regulation Branch
Ontario Securities Commission
20 Queen Street West, 22nd Floor
Toronto, ON M5H 3S8
Fax (416) 595-8940
Email: marketregulation@osc.gov.on.ca

Comments received will be made public on the OSC website.

Questions on the content of this Notice may be referred to:

Tracey Stern
Manager, Market Regulation
Email: tstern@osc.gov.on.ca

Jonathan Sylvestre
Senior Accountant, Market Regulation
Email: jsylvestre@osc.gov.on.ca

Paul Romain
Trading Specialist, Market Regulation
Email: promain@osc.gov.on.ca

Questions regarding the Aequitas' Proposal and the content of Appendix A to this Notice may be referred to:

Randee Pavalow
Chief Compliance Officer & Legal
Aequitas Innovations Inc.
Email: randee.pavalow@aequin.com

August 13, 2013

APPENDIX A

APPENDIX A

SUMMARY OF AND RATIONALE FOR PROPOSED TRADING STRUCTURE AS PREPARED BY AEQUITAS INNOVATIONS INC.

Aequitas Innovations Inc.

Innovation for Fair Markets

Aequitas [ekwitæs]: Fairness in Latin

Aequitas Innovations Inc. (Aequitas) is a Canadian corporation that seeks to apply innovation, technology and competition to promote fairness generally and specifically to rebalance interests in the markets towards traditional investors and issuers – the cornerstones of our economy.

In response to developments and current issues in global equity markets, Aequitas has developed a commercial proposal to establish a marketplace which will focus on innovative solutions to address future and existing challenges through its market structure and complimentary services. This proposal introduces new concepts and approaches. As part of its feasibility analysis, Aequitas approached securities regulators to review key parts of its proposal. Although Aequitas intends to file a full application for recognition as an exchange which will be subject to the comment process, at this time it is publishing a description of its proposed market structure and its views on the key regulatory concerns that have been identified regarding this part of its proposal.[1]

After introducing Aequitas (Part I), this paper will set out a description of Aequitas' view of the role of a marketplace (Part 2), the Aequitas proposal (Part 3), and then its views on the regulatory issues (Part 4).

[1] It should be noted that Aequitas is still in the feasibility stage and could decide not to proceed for reasons other than regulatory concerns.

1. Introducing Aequitas

a) The Initiative Leaders

The Mission Statement of Aequitas is:

> ***"To create an exchange in Canada that provides an innovative and cost-efficient marketplace which protects the interest of all investors and reflects the fundamental purpose of markets: the efficient allocation of capital between issuer and investor as a central force driving the Canadian economy"***

Aequitas was founded by a group of stakeholders[2] who believe today's equity marketplaces, both in as well as outside of Canada, do not provide the public with the fairness, efficiency and choice required to encourage confidence and participation by investors, issuers and dealers. The concentration of services, dominant market structure model and lack of innovation often discourages marketplace participation by these parties rather than fostering it.[3]

We believe that by properly leveraging technology, efficiency and innovation, this objective can be achieved through a commercial organization such as Aequitas.

b) The Rationale

One of the consequences of the demutualization of stock exchanges has been that most exchanges now focus on short-term profitability, which can come at the expense of longer-term objectives and the needs of their most important stakeholders: investors and issuers.

Today, these venues cater to volume generating electronic trading firms (often referred to as High Frequency Traders – "HFTs") and increasingly take investor and issuer participation for granted. This occurs despite investor confidence concerns, capital raising challenges, and the harsh financial conditions facing many of the dealers focused on serving them.

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[2] Our stakeholders include professional money managers, pension funds, sell-side institutions and issuers who believe there is a misalignment of current marketplaces' commercial interests with that of traditional investors, issuers and dealers. This raises concerns regarding the long-term health of our equity markets, the collective needs of investors, issuers, and intermediaries and, as a result, the public at large.

[3] We would like to note that our views are not intended to suggest that regulators have not appropriately acted to address these issues or that they should do so directly. We believe that commercial solutions and competition among organizations with different approaches are the preferred means for addressing market quality issues and therefore contributing to economic growth and employment in Canada. Through Aequitas, market participant leaders have joined forces with the goal of establishing a commercial enterprise whose prime objective is to promote market quality.

This situation is exacerbated in the Canadian context by the recent move towards a large concentration of market power in a single marketplace services provider.[4]

In our view, competition is the preferred way to foster efficiency and innovation, thereby enhancing confidence in Canada's capital markets. For competition to be effective, it should provide alternatives to the models that currently exist. More of the same will not address emerging issues or the issues that exist in today's markets – it will only lead to gaps in services and imbalanced burdens, costs and inefficiencies[5].

Within the context of today's markets, we offer a uniquely differentiated vision of how a marketplace should function and whom it should serve. Specifically, Aequitas proposes:

- A broad representative ownership and governance structure built on a core founding principle to foster market integrity and the public interest;
- Advisory committees that will give investors and issuers a strong voice;
- Solutions designed to enforce fairness and encourage investor confidence in Canada's equity markets, while providing issuers with a capital formation toolset that will promote their success and growth;
- Technology that promotes market integrity by helping to eliminate the most prevalent predatory and opportunistic trading strategies;
- A plan to promote fair and sustainable market making which will support the liquidity needs of investors and issuers; and
- Innovative and affordable services positioned to place meaningful competitive pressure on incumbent players.

[4] The TMX Group accounts for approximately 85% of the equity trading, 100% of the trading of exchange traded options and futures contracts, 100% of the clearing of equity, fixed income, and derivatives instruments, 95% of the equity listings and over 85% of the market data fees in Canada.

[5] Dave Lauer, "HFT: In Search of Truth" (Tabb Forum, June 14,2013), in his reflections on whether high frequency trading is impacting market structure changes, points out: "In other words, a market that is becoming more self-similar is a market more prone to positive feedback loops, illiquidity contagions, and gnerally non-linear behavior. It's a market that is less resilient and more prone to instability."

2. Aequitas and the Role of Marketplaces

a) Role of Marketplaces

The role of a marketplace that provides listing and trading services is to facilitate efficient capital raising and transfer between issuers and investors and among investors.[6] It performs that role by trying to achieve the following objectives:

- Create services which consider Issuers' and Investors' interests first;
- Facilitate sustainable and reliable market making to enhance natural liquidity;
- Enhance natural price discovery by bringing together investors with different needs (including speculative trading and arbitrage);
- Achieve market Integrity by preventing and/or policing inappropriate behaviours;
- Promote fairness by taking into account the different needs of investors and appropriately treating different types of trading strategies; and
- Leverage competition to manage costs and enable Innovation.

Exchanges and marketplaces in general, are like any other business in that they develop specific products and services to attract desirable clients and achieve their business objectives. We believe the regulatory framework should not require all exchanges to provide the same services or to have the same business model.

This is consistent with the IOSCO Principles of Securities Regulation, which are based upon the following three objectives: the protection of investors; ensuring markets are fair, efficient and transparent; and the reduction of systemic risk.

More specifically, IOSCO Principle 34 states:

> *"There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through* ***fair and equitable rules that strike an appropriate balance between the demands of different market participants"****. [sic, bold added].*

[6] Wallace C. Turbeville, *"Cracks in the Pipeline Part Two: High Frequency Trading"* (March 8, 2013) states that the most important social purpose of financial markets is to facilitate the movement of funds from (a) holders that seek investment opportunities to (b) businesses and governments who need to put investment capital to work in productive ways and to individuals who seek to borrow for their current needs.

b) A New Approach to Market Structure should be Evaluated by the Objectives it is trying to Achieve and its Impact on Key Values

The equity markets are constantly changing as a result of technology, business model needs, and regulation. We believe any new proposal should be judged by the services it brings and what values it is trying to achieve. Our proposals are designed to achieve[7]:

- price discovery;
- liquidity;
- competition;
- innovation;
- market integrity[8]; and
- fairness.

Aequitas is proposing commercial solutions to market structure challenges that will include choices for market participants who are disadvantaged in the current environment or are looking for different ways of executing their mandates to achieve their clients' needs. It will improve the price discovery process through its Hybrid Book (as discussed below), strengthen liquidity by increasing confidence in our markets, and focus on committed market making.

3. Aequitas proposal

Aequitas' proposed market structure combines the following features: multiple order books, innovative approaches to matching priorities and market making, as well as prohibitions on the behaviors of certain participants. These features are the foundation of a trading eco-system that:

- Provides options to traditional investors (retail and institutional) who are disadvantaged by the current dominant market model;

[7] These were the objectives identified in the Joint OSC/IIROC Notice on Trade-through Protection, Best Execution, Access to Marketplaces and the Consolidation of Data, 30 OSC Bulletin, Issue 16s (April 20, 2007). The Notice states:

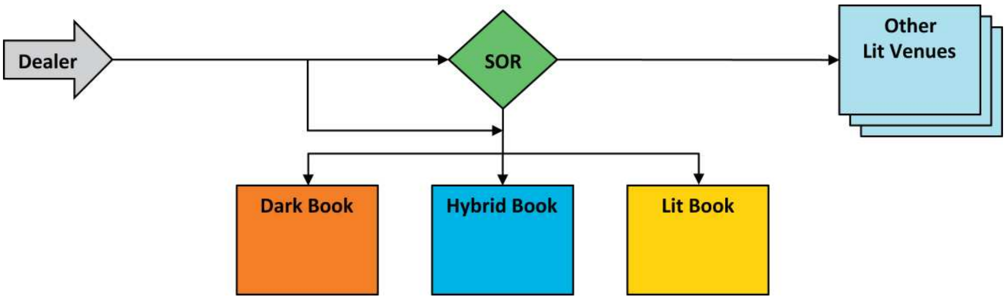
> *"Through our consultations and review of recent studies, we have noted that most market participants believe that the ideal or preferred equity market structure is to have integrated marketplaces. Although this does not mean that there would be mandatory linkages between marketplaces, the theory is that, to reduce the negative impact of multiple marketplaces trading the same securities, there should be access to information and orders.* ***The reasons or values in determining the preferred market structure ("objectives") reflect the following: price discovery, liquidity, competition, innovation, market integrity and fairness."*** *[sic, bold added]*

[8] See Appendix "A" for some of the issues identified by market participants.

- Recognizes the role of committed market making – with clear benefits *and* responsibilities;
- Discourages strategies that are damaging to perceived fairness and market confidence; and
- Offers a viable alternative to rebate incentives and maker-taker pricing which Aequitas believes have adversely impacted market quality.

The following diagram illustrates the high-level marketplace design of the Aequitas eco-system[9]:

Diagram 1: The Aequitas basic Market Structure Eco-system



The foundation of our proposed market structure solution is the establishment of three core order books: Dark, Hybrid and Lit.[10] Each is designed to serve a separate yet integrated role in the Aequitas eco-system. Integrating these order books with other marketplaces is a smart order router ("SOR") solution.

Next, we will describe the proposed structure and objectives of each of the three core order books.

a) Aequitas Dark

Similar to existing dark pools operating in Canada today, Aequitas Dark would offer no pre-trade transparency. It would comply with Canada's rules regulating dark orders (the "Dark Rules"). This means that matching would occur at the mid-point of, or at least one standard price increment from, the National Best Bid and Offer ("NBBO"), or at the NBBO for active orders provided they are for at least 50 standard trading units or $100,000 in value.

The opportunity to take liquidity will only be available to retail and qualifying institutional parties – but not HFTs. The objective of this restriction is to prevent predatory HFT trading strategies and encourage quality resting liquidity. To implement this limitation, the Dark

[9] Patent applications have been filed for the Aequitas proposals.
[10] See Appendix "B" for a summary of features of the three books.

Book will use the designation of "Non Short-Marking Exempt" (Non-SME) orders[11] to identify which kinds of order flows are permitted to take liquidity.

There are no proposed restrictions on the type of order flow that may provide liquidity in Aequitas Dark. Parties posting in the Dark Book will have additional options to specify minimum quantities on counterparty size and fill size, and to interact only with active retail orders or contra resting liquidity.

The proposed matching priority is as follows: price, broker, market maker for its allocated security, and weighted size/time.

The Aequitas Dark fee model will not be a maker / taker fee model.

Aequitas Dark has been designed to encourage natural passive liquidity and market making while restricting SME participants from taking liquidity in a predatory fashion.

b) Aequitas Hybrid

The Aequitas Hybrid Book[12] is so named because the display of orders will be based on the NBBO set outside of the Hybrid Book and will be limited to the aggregate size of the passive orders at each price level at or within the NBBO (market by price and not market by order). This information will be available to data vendors.

The price of orders can be set by pegging to the NBBO, in a similar way to dark pools. Limit orders will also be permitted but will only be executable at or within the NBBO. Taking liquidity (active flow) would be limited to Non-SME flow. All types of order flow may provide liquidity (both Non-SME and SME).

The proposed matching priority is the same as the one proposed for the Dark Book: price, broker, market maker for its allocated security, and weighted size/time.

The Aequitas Hybrid fee model will not be a maker / taker fee model.

The rationale for the Hybrid structure is the same as for the Aequitas Dark: to suppress predatory trading practices and promote quality resting liquidity – in this case, partially visible liquidity. We believe that the transparency regarding information on orders at or

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[11] "Non-SME" orders will be identified as permitted accounts/orders that have not been marked "Short-Marking Exempt" (i.e., not an arbitrage account, an account of a person with Marketplace Trading Obligations, or an account which is fully automated and does not have more than a nominal position at the end of a trading day) as defined in UMIR 1.1. We have carefully considered how to define the acceptable liquidity taking flow taking into account both the objectives we are trying to achieve and the practicality of achieving effective monitoring of compliance. We are willing to consider refining the definitions to address any relevant issues.

[12] Aequitas has filed a patent for its Hybrid Book.

within the NBBO will promote better price discovery, while displaying only aggregate resting liquidity will protect against information leakage.

c) Aequitas Lit

The Aequitas Lit Book is a more common lit book without any liquidity taking restrictions. It will offer the prevalent maker-taker pricing mechanism employed by many lit marketplaces.

While Aequitas is of the opinion that the maker-taker fee model has generally had a negative impact on market quality, we intend to offer such a book in order to compete with the current dominant order book models offered in the marketplace. It is our intent to benchmark our lit "take" fees generally to the "take" fees in the Canadian marketplace.[13] Our commitment is to lower our fees in tandem with any reduction in take fees in Canada. We believe that providing alternative commercial solutions along with our commitment to lower fees will place pressure on the maker-taker model to evolve to a different fee model for all marketplaces in Canada.

The matching priority or allocations will be based on the following order: price, broker preferencing, Non-SME then time in the book. There will be market maker obligations, including responsibility for the auto-execution of odd lots.

All of the proposed priority preferences set out above for each of the books, except for Non-SME order preferencing, exist in today's current environment and marketplaces.[14].The type of priorities or rules for allocation are not tied to whether the marketplace is lit or dark but depend on the objectives that the marketplace is trying to achieve (promotion of large trade sizes, rewarding market makers, or competing with other exchanges' programs). Aequitas is introducing a preferencing for Non-SME orders because it is consistent with its quality of execution objectives[15].

d) Committed and Sustainable Market Making

Aequitas intends to offer a market making program for both Aequitas-listed securities and securities listed on other exchanges. We have decided to provide the same type of market making program both for securities listed on Aequitas and for securities listed on other exchanges because the objectives of better liquidity and price discovery are applicable no matter the source of the listing. Designated market makers will have performance

[13] Currently TSX charges 35 mils to take for high priced securities.
[14] See Minimum Guaranteed Fill on TSX; see also Nasdaq OMX PSX. The TSX has had a long standing practice of giving Registered Traders (TSX market makers) preference in executions in return for assuming obligations.
[15] We invite comments or suggestions on how to better achieve our objectives (strengthening execution quality for traditional investors and improving market making programs). Please contact Aequitas directly to provide comments or to request a meeting to discuss its Proposal.

obligations (spread, depth and presence) for their securities of responsibility. Market maker obligations would be fulfilled in the Aequitas Lit Book.

In their paper, Anand and Venkataraman[16] note the need for new compensation programs for market makers by listing the following arrangements that have emerged over time across multiple marketplaces:

- "The floor-based NYSE system provided the specialist with access to privileged order flow information such that liquid stocks subsidize the illiquid stocks;
- The TSX, in certain cases, allows the DMM (formal market maker) to trade ahead of orders with higher time priority in the book; DMMs accept obligations for a portfolio of liquid and illiquid stocks;
- In Euronext-Paris and Stockholm, the listed firm enters into a liquidity contract with the DMM and pays an annual fee for market making services; and
- Some U.S. based market centers compensate the DMM using fees from data feeds, or providing higher credits for posting limit orders in the book."

At the current time there is no evidence of the optimal design for a market making program; however it is clear that marketplaces are recognizing the importance of liquidity commitment and the need to compensate the providers for risk and cost.

Aequitas is proposing a robust market-making program that refocuses the market maker on the obligation to provide reliable liquidity. In order to do this, the market maker needs to be compensated for its obligation to execute undesirable trades, its inventory risk, and its cost of capital[17]. The compensation that Aequitas proposes for market makers is matching priorities in the Dark and Hybrid Books, where they are not exposed to predatory flows. Aequitas is also considering issuer participation in the market making program, and preferential trading fees for its market makers.

Aequitas' vision emphasizes inclusiveness and enabling those who can add value and improve market quality. Aequitas would require market makers to be IIROC members who are members of the Aequitas Exchange, but also proposes allowing Direct Electronic Access ("DEA") clients who are not IIROC members to act as market makers provided their sponsoring dealer agrees to be accountable for their actions. We believe that a model that allows sponsored DEA clients (where the dealer member as well as the DEA client remain liable for any regulatory obligations) to be market makers for both Aequitas-listed

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[16] Anand, Amber and Venkataraman, Kumar, "Should Exchanges Impose Market Maker Obligations?" (November 21, 2012); available at SSRN: http://ssrn.com/abstract=2179259.

[17] Jennifer Victoria Christine Dean,"Paradigm Shifits & Unintended Consequences: The Death of the Specialist, the Rise of High Frequency Trading, & the Problem of Duty Free Liquidity in Equity Markets" (March, 2013), http://ssm.com/abstract= 224924, states that regualtory changes, faster technology and structural market changes have led to the disappearance of exchange specialists. She further notes that while specialists or market makers were not perfect, they could be held accountable which ensured market liquidity in times of crisis, thereby decreasing volatility and helping to maintain a fair and orderly market.

securities and other listed securities is appropriate. Currently, DEA clients are allowed on Alpha Exchange to be market makers for non–Alpha listed securities; however their obligations are limited to odd lot executions. There has been no evidence of any additional risk or harm from this approach. Aequitas would like to extend this approach with additional obligations to Aequitas-listed securities as well as to securities listed on other exchanges because it is consistent with its model and the current environment. Aequitas proposes to add additional eligibility criteria by requiring the DEA client to be a regulated entity subject to regulatory oversight by an acceptable SRO such as FINRA or a government entity such as the SEC, and/or to be a designated market maker on an existing exchange. This should mitigate if not eliminate any risks. In addition, Aequitas believes that it can address any potential remaining risk concerns through monitoring and by providing reporting tools for both the DEA client and its sponsoring dealer.

We believe this will foster liquidity in a greater number of listings and encourage a larger spectrum of firms with market making capabilities to participate as market makers with liquidity obligations and, therefore, provide more meaningful value to the markets.

For securities of responsibility, priority in the Aequitas Dark and Hybrid Books would be the primary incentive offered to market makers. Aequitas believes granting priority in these books will be a valued functional benefit for market makers, and, importantly, one that does not rely on a financial subsidy based on maker-taker. We believe that the opportunity to obtain matching priority in books which are protected against predatory flow will prove attractive to prospective market makers.

4. Aequitas Market Structure Solutions do not violate Fair Access and OPR, nor create Negative Consequences for Price Discovery

a) Fair Access – regulatory definition, policy consideration and Aequitas position

National Instrument 21-101 - *Marketplace Operation* ("NI 21-101") establishes that "A marketplace must not unreasonably prohibit, condition or limit access by a person or company to services offered by it."[18]

First, we note that the fairness standard is not absolute but has a test of reasonableness.[19] Second, in our view, the focus of this requirement has generally been on unfairly discriminating against non-members or non-subscribers rather than prohibiting or limiting differentiation of services within a marketplace.[20] The Aequitas restriction on SME active order flow in its Hybrid Book is being proposed to allow traditional investors to avoid the harmful behaviours present in existing lit markets that put them at both a cost and execution quality disadvantage. Limiting access should not be considered unreasonable where it supports market integrity and addresses harm in the marketplace. In addition, non-members will have the same access as members.

Evidence that market quality and market integrity is under threat is supported by the following:

- Displayed spreads are no longer the real spreads at which market participants can trade (as shown in Diagram 2); while displayed spreads may seem to have narrowed, the real spreads at which traditional investors trade have been subjected to an increasingly volatile intra-day price path[21], a result of predatory trading strategies;
- The displayed picture of liquidity supply is distorted and no longer reliable for traditional investors;

[18] It should be noted that the original provisions of NI 21-101 were aimed at access to a system (the exchange or marketplace) and not a service. In fact this is still the requirement in the U. S., which was the basis of the Canadian requirements. See, *Regulatory Issues Raised by Changes in Market Structure*, S. 3.3 (a) of IOSCO Consultation Report (March 2013), hereafter referred to as the "IOSCO Consultation Paper". In addition, the U.S. has only applied the fair access requirements to those marketplaces that account for a significant percentage of the trading of a security. See Exchange Act Rule 301(b)(5). The SEC excluded from the fair access requirements those alternative trading systems that match customer orders for securities with other customer orders, at those prices for those same securities established outside such system. Thus the Canadian approach appears to be more restrictive than that taken in other jurisdictions.

[19] The Final Rules of the SEC adopting the ATS Rules specifically stated that a denial of access is reasonable if it is based on objective standards. The Notice gives the example of an ATS that allows institutional subscribers the choice of refusing to trade with broker-dealer subscribers and states that this kind of restriction or limitation would be reasonable as long as the choice is based on fairly applied standards. See, p. 97.

[20] See SEC Release No. 34-5870 discussion of Rules 610(a) and (b), p. 166.

[21] Lauer, id., cites Andrew Haldane of the Bank of England, who found in his July 2011 study that "intraday volatility has risen most in those markets open to HFT. ...HFT algorithms tend to amplify cross-stock correlation in the face of a rise of volatility" indicating individual risks are made more systemic.

- Overwhelming amounts of market data are produced by HFTs leading to stale data and/or increased trading costs for everyone processing data; and
- Small-cap and mid-cap securities are in a downward liquidity spiral as a consequence of true market makers leaving the markets due in part to the impact of HFT activity.

Diagram 2: Volumes, Spreads and Intraday Volatility in Canadian Markets *(Evolution of Canadian Equity Markets, RBC, February 2013)*

We would also like to highlight that "fair" access does not mean the "same" access. We have traditionally permitted marketplaces to limit access to just registered dealers or even to just institutions (e.g., Liquidnet). The fair access requirements were intended to avoid arbitrary differentiation and to encourage access to information and integration among marketplaces. The Aequitas differentiation is not arbitrary because it promotes better quality markets as described in this paper. In this regard the Hybrid Book is very innovative as it is a semi-transparent book that will not be affected by predatory trading activities or the negative effects of a maker-taker model. We believe this will not only be beneficial for traditional trading strategies based on economic value, but that it will shed a new light on price discovery by allowing the true economics of transactions to re-emerge. We also believe that a transparent segmented book based on type of flow will act as a reference point curtailing falsely induced signals in other lit books. This will be beneficial to issuers and overall investor confidence.

The Staff Notice and Request for Comments suggests that limits on fair access have been restricted to dark markets and not permitted in lit markets, and that there has been no discrimination based on types of participants. As to the first point, the approach taken by some marketplaces[22] to limit access to dealers was and is still applicable to lit markets. This approach was based on considerations of credit rating and shared industry standards to address risks. This is a precedent for restricting access to the marketplace overall where there is an appropriate reason. In response to the second point, Aequitas would like to emphasize that its objective is to favour types of flows or trading strategies rather than types of participants.

b) OPR – regulatory definition, policy considerations and Aequitas position

National Instrument 23-101 - *Trading Rules* ("NI 23-101") contains requirements that each marketplace must establish and maintain written policies and procedures that are reasonably designed to prevent trade throughs on that marketplace (i.e. when a trade occurs at an inferior price than what is available on another marketplace). Order protection only applies to a protected order (an order that is visible and displayed by a marketplace that provides "automated functionality"). It must be filled before other limit orders at inferior prices, regardless of the marketplace where the order is entered (the "OPR").

In evaluating whether the OPR should be applied to the Hybrid Book, we agree with OSC Staff that consideration should be given to the policy objective that the OPR was intended to achieve. Part of the reason it was implemented was "to ensure the future participation of retail investors which have an historical expectation of such protection." Another key concern was the impact on the price discovery process.[23] Additional guidance is provided by Regulation NMS in the United States, which was the impetus for the review and approach taken in Canada. The SEC, in its Request for Comments on Regulation NMS (Release No. 34-50879), focused on the objectives of increased market depth and liquidity. In its adopting release (Release No. 34-51808), it indicated that its Commission was guided by a firm belief that one of the most important goals of the equity markets was to minimize the transaction costs of long term investors. It was believed at that time (June 2005) that generally the interests of minimizing costs for long term investors and the liquidity that would be created by Regulation NMS would not be in conflict. As we have described in this paper, the quality of the liquidity that exists in today's markets does not necessarily reduce costs for the long term investor and in some cases is in conflict.

We believe the original circumstances which gave rise to Regulation NMS and the OPR do not exist today. First, the interests of long term investors and those who rely on speed with

[22] There are marketplaces which allow access to different types of organizations. See Chicago Mercantile Exchange.
[23] CSA Notice of Amendments to 21-101 and 23-101 (November 3,2009).

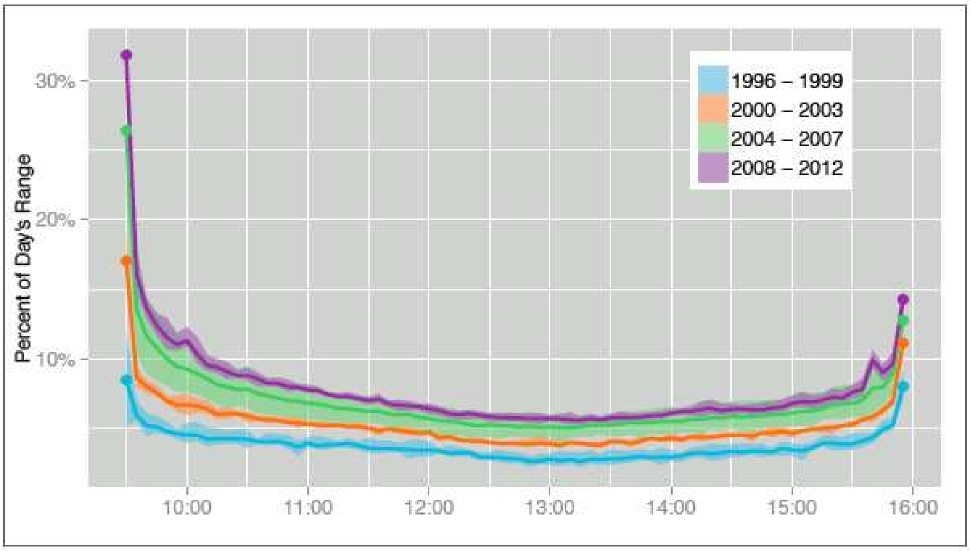
short term objectives are at minimum imbalanced, and in fact can be considered to be in conflict.

Many market participants have expressed concerns that significantly increased intraday trading activity has made trading considerably more problematic for institutional investors. For example, Turbeville states:

> *"Bid/Ask spreads may not widen with HFT activity, but price levels are altered to the detriment of large institutional investors that transact large positions. HFTs eliminate all meaningful depth of interest for a short period of time"*.[24]

Aequitas believes that today's market structure has also had an impact on retail investors. See data set out in Diagram 3 below.

Diagram 3: Shift in Intraday Trading Ranges *(The Cost of Penny Spreads, RBC, April 2013)*



The analysis above shows the shift in short-term price volatility has been most dramatic during the early morning session – thereby suggesting a demonstrable impact to retail trading activity which tends to trade particularly heavily during this time period. Similar developments have been observed in other markets such as the U.S.

IOSCO has also recently considered the objectives of trade through protection as part of its review of matters relating to market fragmentation. Its Consultation Paper describes trade through protection as based on the obligation of a participant "to the market 'as a whole' and is grounded in the desire to protect visible accessible limit orders. It aims at ensuring that those who decide to display the prices they are willing to pay for or receive for a

[24] Turbeville, ibid.

particular security can obtain the benefit of that decision."[25] For that reason, the OPR obligation is placed on the marketplace so that it cannot execute a trade on its own marketplace if there are better priced orders available on other marketplaces.

We believe that the Aequitas Hybrid Book does not contravene the spirit of the OPR or the objectives discussed by IOSCO in the sense that Aequitas trades will not occur at an inferior price since all trades will be at or within the NBBO. In addition, retail and institutional flow will be able to route to Hybrid and access all passive orders. The potential violation of the OPR is limited to trades of SME parties that might occur on other marketplaces at a price inferior to what is available in the Hybrid Book, since the SME orders will not be eligible for entry as an active order[26] in the Hybrid Book. We believe we need, however, to remember that OPR was not intended to protect SME type order flow.

While Aequitas has agreed to make the information in the Hybrid Book available to the Information Processor (IP) because it believes it can be beneficial to price discovery in the Canadian market, we also believe that the Hybrid Book information should be characterized as information based on a reference price, i.e. all resting orders are pegged to or bound by the NBBO before being able to trade and in that sense are similar to trades in a dark pool. Therefore, like a dark pool, the Hybrid Book should be considered as not subject to the OPR[27]. If it is found that providing some information to the IP technically subjects the Hybrid Book to the OPR, then Aequitas will seek an exemption from the OPR for the Hybrid Book so that it would be designated as a marketplace with unprotected orders. The OPR, by its own requirements[28], acknowledges that not all orders or marketplaces should be subject to order protection. The concept of the Hybrid Book was not contemplated at the time of the finalization of the rule amendments implementing the OPR and therefore should not be determinative of whether an exemption is appropriate. Since the Hybrid Book is being constructed with retail investors in mind and should have a positive impact on the price discovery process, an exemption would be consistent with the objectives of the OPR.

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[25] Ibid., see Section 3.3(c).
[26] It should be noted that SME orders can be routed to the Hybrid as passive orders.
[27] Note that in the EU, MiFID permits competent authorities to grant exemptions from marketplace requirements, and waivers have been granted from requirements that would otherwise apply on the basis that prices are set based on a reference price system.
[28] See Section 6.2, NI 23-101 for examples.

c) The Hybrid Book would not undermine recently adopted Dark Rules[29]

The Hybrid Book is part of an overall market structure proposition that Aequitas developed in response to market conditions that either were not as prevalent at the time the rules (OPR and Dark Rules) were formulated or have evolved since then.

The IOSCO Consultation Paper recommends monitoring the impact of fragmentation, but it also acknowledges that as marketplaces evolve, the regulatory framework should evolve as well.[30] Regulators are encouraged to evaluate the regulatory requirements to ensure that the regulatory requirements are appropriate to the facts, with due consideration to the different functions they perform (see IOSCO Recommendations 1.1 and 1.2).

Rules should be interpreted in light of current circumstances; and exemptions, if needed, should be given if the objectives of the innovation are not inconsistent with the underlying policy of the specific rules as well as the market quality objectives identified by the Canadian securities regulators.

The principal objective of the Dark Rules was to address concerns regarding the potential impact on the price discovery process as the quantity of the trades in the dark increased over time. In order to address these concerns, the Dark Rules require that any orders less than 5000 shares or $100,000 in value must be executed in a lit marketplace unless there has been price improvement, and that lit orders should have priority over dark orders[31] at the same price.

The structure of the Hybrid Book has been created to provide additional transparency that doesn't exist in the dark marketplaces and therefore will promote price discovery. We do not believe that the proposal undermines the Dark Rules.

d) Impact of limiting active flow to Non-SME Orders and of Hybrid Book on price discovery – policy considerations and Aequitas position

The main objective of exchanges from the very early days of their creation was to bring together interested parties to trade. It was believed that bringing together the interested parties would promote a more efficient price discovery mechanism by reducing search costs and allowing more parties to participate in the process. The objective of the price

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[29] While we are not questioning the appropriateness of the Dark Rules, we note the opinion in the April 2013 Tabb Report that they have resulted in two problems: first, retail orders were "hit the hardest by the flight of liquidity providers; and second, no alternative was offered." The Report indicated that since institutions have "nowhere to hide", they are likely to trade more blocks, which will have a negative impact on the volume executed on the lit markets.

[30] Ibid., see section 4.3.

[31] A "dark order" has been defined as: (a) an order no portion of which is displayed on entry on a marketplace in a consolidated market display; or (b) that portion of an order which on entry to a marketplace is not displayed in a consolidated market display if that portion may trade at a price other than the price displayed by that portion of the order included in the consolidated market display.

discovery process was to facilitate the establishment of price based on true supply and demand. Over time, theories such as the efficient market hypothesis were developed to explain why bringing together the interested parties works.

While there is wide agreement regarding the desirability of efficient price discovery, there is no single best way to achieve it.[32]

In addition, there is no one model for measuring it either. Research is prolific but often characterized by lack of reliable and granular data, by ambivalence in the conclusions (usually aligned with the interests of the sponsor) and by the use of methodologies that are no longer applicable in today's world (e.g. periodic snapshots of prices, mid-point pricing, spread to analyze quality, etc.).

For example, Turbeville believes that the various studies that examine the narrowing of spreads miss the crucial point that the narrowing is an illusion.[33] This viewpoint is clearly supported by RBC's recent research on the long-term shift in intraday price volatility in Canada (see Diagram 2 above).

Credit Suisse Europe produced a market commentary in its Portfolio Strategy Report (January 2011)[34] that noted the following key points: 1) those who claim trading in the dark harms price discovery rarely define what price discovery is; 2) it endorsed Ohara and Ye (2011) proxies (short-term volatility, variance ratio and return autocorrelation) for measuring impact; and 3) it provided an analysis based on those proxies that showed there is a lack of statistically significant impact from the trading in the dark in Europe on the price discovery process.

In addition, there is evidence that the current quality of resting orders is overestimated. Eric Hunsader, the founder of Nanex stated:

> *"In summary, HFT algos reduce the value of resting orders (for example, a Market Maker's order) and increase the value of how fast orders can be placed and cancelled. This results in the illusion of liquidity."*[35]

Since there is no similar model to the Aequitas proposal (in particular the Hybrid Book) and therefore no research available at all, it is difficult to assess the impact of the proposed

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[32] There are those who have argued that a pure price time priority model with full transparency is the way to achieve it; however we have seen over time that this model does not suit all interests and rarely exists in the purest form. It also can not exist across a fragmented market.

[33] Turbeville, ibid.

[34] Credit Suisse Portfolio Strategy (January 2011) analyzed the impact of the small bid/ask imbalances in FTSE 100 and Euro STOXX 50 names and concluded that small imbalances do have an adverse impact on price movements, which it believes is likely due to traders attempting to slip ahead of the bid/ask price. This is another suggestion that quality of price discovery is declining due to behaviour in the lit rather than movements to dark.

[35] Cited in Turbeville, ibid.

approach. However, based on our understanding of current issues, we believe the Hybrid Book with NBBO pegged orders and especially limit orders that have to be at or within the NBBO without being exposed to any toxic flows, would improve overall market quality and price discovery.

We believe the Aequitas proposal will improve market quality by allowing parties to quote narrower and more reliable effective spreads in the Hybrid Book to the benefit of all natural flows. In order to achieve this objective, the Hybrid Book would have to be considered an unprotected marketplace. Although the Hybrid Book would not be subject to OPR, the Hybrid Book data would be available to all parties through the IP and other market data distribution channels so that all parties would benefit from this improved price discovery.

Under the Aequitas approach, active predatory trading strategies will only be able to be executed on Aequitas' and other marketplaces' lit books. We acknowledge this may lead to moderately larger quoted spreads on these lit books because HFTs would no longer be in a position to play out their various predatory strategies to the fullest extent in an environment where natural flows can access books that are free from these strategies (Aequitas Dark and Hybrid Books). However, we again stress that the spreads quoted on lit books are not the effective spreads at which investors can trade. We believe this evolution will be beneficial to the markets and market participants at large, as it will lead to a more reliable price discovery mechanism and reduced intraday price volatility – in short, a more efficient marketplace.

Our attention was directed to two recent research papers reviewing the impact of different flows moving from the lit markets to dark markets.[36] Regardless of the fact that we believe that these two papers present some methodological flaws, the scenarios considered are not directly applicable to Canada or Aequitas. Both aim to demonstrate that segmentation as applied across alternative venues (dark in Australia / non-NMS in the US), impact price discovery and price efficiency. The underlying theory is that optimal price discovery and price efficiency result from the unrestricted interaction of informed and uninformed flows and that venues that restrict that interaction by deciding who can trade with whom will lead to price discovery issues and price efficiency issues (this is typically what "internalizers" do, as well as many of the US or Australia based dark pools).

Intuitively we agree with that theory but we emphasize that it is not the model that Aequitas proposes. In its Dark and Hybrid Books, Aequitas restricts active flows to retail and institutional non-SME order flows (without limitation on participants), and it allows all flows (without limitation on participants) to interact with these active flows. Therefore, there is no restriction on informed and uninformed flows interacting.

[36] Comerton-Forde & Putnins, "Dark Trading and Price Discovery" (November 2012); Hathaway, Kwan and Zheng, "An Empirical Analysis of Market Segmentation on U.S. Markets" (November 2012).

Preventing the separation of different trading strategies in the Dark and/or Hybrid Books will not address the issues underlying the current challenges to the quality of the lit markets, but will merely force parties to go to the lit markets even if they are at a disadvantage there, and/or reduce the size of their orders within a highly toxic and detrimental environment. Providing an alternative to current lit markets for traditional retail and institutional investors will encourage better market quality across all venues.

e) Matching priorities

Market maker prioritization aims to provide true market makers with appropriate compensation for their services across both liquid and less liquid securities and this, as demonstrated by the Anand and Venkataraman research paper, using TSX data, is critical.[37] They conclude that liquidity providers without obligations consistently provide liquidity in large-cap stocks; otherwise their participation tends to be "sparse and opportunistic." On the other hand, designated market makers (those with obligations) are more likely to stabilize prices and supply liquidity especially for thinly traded medium- and small-cap stocks, the vast majority of listed stocks.

Other academics have examined the change in market quality and possible valuation effects when a formal and successful market-making program is introduced[38]. Anand and Venkatatraman point to Nimalendara and Petrell (2003), who report that trading volume increased and bid/ask spread declined on the Italian Stock Exchange. On the Paris Bourse, it was found that formal market makers were used more frequently for smaller and less volatile companies. At the time of the introduction of the program, stocks experienced a cumulative return of nearly 5% that was positively correlated with improvements in liquidity.[39]

By allowing market makers to have priority over time in the Dark and Hybrid Books, Aequitas believes that price discovery and price efficiency will be improved. We don't anticipate that this form of prioritization will lead to an artificial narrowing of spreads as is the case with the maker/taker model, because market makers will also provide liquidity for less desirable trades that impact their profitability, inventory risk and capital cost. The priority provides compensation, not a means to artificially impact pricing.

This type of prioritization eliminates small quantity liquidity provision and the book fading we see in today's lit markets, one of the typical passive HFT predatory strategies leading to increased intra-day volatility. The experience with Alpha IntraSpread (as shown in

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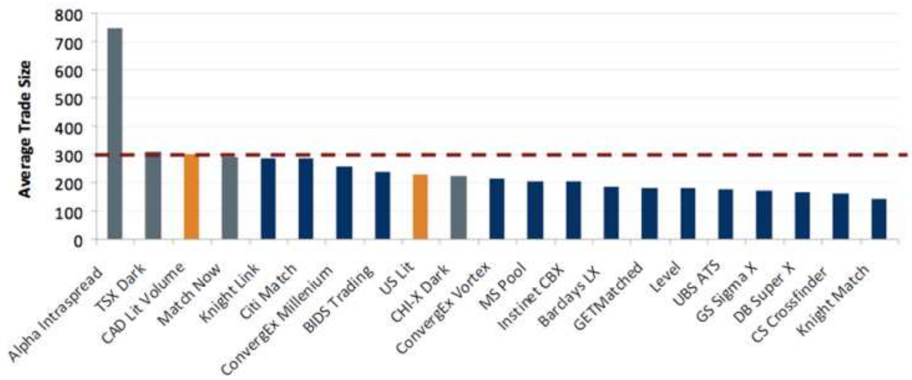
[37] Anand and Venkataraman, ibid.

[38] Dean, id. at p, 235, states that "Market–makers play an important role in providing liquidity to financial markets. There are a number of peer-reviewed studies supporting the use of market-maker obligations in order to bolster market quality. The primary means of accomplishing this task is either by providing incentives or by imposing regulations (affirmative obligations) which lead to meaningful liquidity in times of crisis." Aequitas believes it is necessary to do both.

[39] Venkataraman and Waisburd (2007).

Diagram 4) demonstrates how combining segmentation with this form of liquidity provision policing, led to an increase in average trade size and better fill rates.

Diagram 4: Average trade size of multiple dark pools *(RBC Capital Markets Client Brief, March 2013)*



By providing Non-SME priority in Aequitas' Lit Book, we anticipate similar improvements in the Lit Book, while ensuring that unsophisticated resting retail orders benefit from reliable liquidity.

5. Conclusion

The IOSCO Consultation Paper states[40]:

> *"Securities regulators bear the responsibility for striking an appropriate balance between a market structure that promotes competition among markets, and one that minimizes the potentially diverse effects of fragmentation on market integrity and efficiency, price formation, and best execution of investor orders."*

We would like to acknowledge that many of the issues raised by Aequitas have been identified by other market participants and/or the regulators. In fact, the securities regulators in Canada and elsewhere in the world have been reviewing the issues and considering policy action on a variety of the issues touched upon in the Aequitas proposal.

It is Aequitas' position that commercial solutions should be encouraged and allowed to proceed while the debate and discussions continue. In fact, it would be detrimental to our market and market participants to delay or prevent new solutions from proceeding while policy debates occur. This is especially true if these new proposals can address concerns that already exist in the marketplace. On the other hand, marketplace participants,

[40] Ibid., see section 4.2.

including exchanges, must be willing to change their model as rules and circumstances change.

Innovations and commercial responses to client needs and market structure changes should be enabled; provided there is accountability through reporting to the regulators, monitoring and oversight by the regulators, and acceptance by everyone that changes may be required. These commercial proposals and their implementation will likely inform the discussion and assist in developing any future potential regulatory response. Dialogue and action by all parties is necessary to move forward on these issues.

In fact, Aequitas welcomes and intends to seek input from a broad representation of market participants regarding how it can refine its proposal to better achieve its objectives of improving market quality for traditional investors and true market making in support of reliable liquidity.

The OSC Staff Notice and Request for Comments seeks views on whether the Hybrid Book should go forward on a pilot basis but subject to ongoing evaluation based upon a threshold or specific criteria. Aequitas is prepared to proceed on that basis and would willingly undertake to report on its activities and be evaluated based on clear criteria.

APPENDIX "A" TO AEQUITAS' SUBMISSION

Concerns about "Predatory" Trading Strategies and Proposed Aequitas Solutions[41]

The SEC breaks HFT behaviors down into four strategies[42]:

- *Market Making*: like traditional market making, this strategy attempts to make money by providing liquidity on both sides of the book and earning the spread (along with rebates from posting);
- *Arbitrage*: trading when arbitrage opportunities arise (e.g. mispricing between Indices, ETFs or other instruments and underlying constituents);
- *Structural*: these strategies seek to take advantage of any structural 'vulnerabilities' of the market or certain participants, and include latency arbitrage or quote stuffing; and
- *Directional*: these strategies attempt to get ahead of – or trigger – a price move, and include order anticipation and momentum ignition.

While market making and arbitrage can be beneficial to markets, they can also mask the negative impact of some HFT strategies[43], typically described as "predatory HFT strategies":

- *Quote Stuffing*: the HFT trader sends huge numbers of orders and cancels;
- *Layering*: multiple, large orders are placed passively with the goal of "pushing" the book away;
- *Order Book Fade*: lightning-fast reactions to news and order book pressure lead to disappearing liquidity; and
- *Momentum Ignition / Exploratory Trading*: an HFT trader detects a large order targeting a percentage of volume, and front-runs it.[44]

The impacts of predatory HFT trading strategies have been described as:

- *Increased intra-day volatility*: this represents an extra cost or tax on other investors ;
- *Exacerbated short-term price volatility*: this impairs market efficiency and the price formation process; and
- *Manipulation of liquidity supply, as well as market data issues*: this distorts the price discovery process.

[41] See, Aequitas Innovations Inc. paper dated June 25,2013 at www.aequin.com for additional information on market quality concerns.
[42] SEC Concept Release on Equity Market Structure (2010).
[43] Credit Suisse - AES Analysis (December 5, 2012).
[44] Adam D. Clark-Joseph, Exploratory Trading (January 13 2013).

The following describes how the Aequitas proposal addresses quote stuffing[45], layering[46], book fading[47]. momentum ignition[48], exploratory trading[49], and concerns about reliable market making activity.

Quote Stuffing. Aequitas' multiple book model, matching priorities and fee structure protect the active flows of traditional investors under this type of scenario by providing them, through the dark and hybrid books, with a safe haven where predatory trading strategies cannot dominate the top of the book, nor benefit from rebates. In addition, Aequitas intends to implement an order to trade management mechanism that will slow down the entry of orders if the participant exceeds its permitted order/trade ratio allowing as such managing the speed and quantity of market data.

Layering. The Aequitas approach prevents trading strategies that execute aggressive strategies in its Dark and Hybrid Books, thus protecting market makers, natural liquidity providers and disciplined HFTs. This allows the latter to be more comfortable to provide stable and resilient quotes. By doing so in the transparent Hybrid Book, this will curtail signaling strategies on other venues. This benefit can only be achieved when allowing for segmentation in a lit book. Aequitas' matching priorities eliminate the entire benefit of pre-positioning orders and its fee structure in the Dark and Hybrid Books does not cater to rebate strategies.

Book fading. The Aequitas segmentation strategy provides for a safe haven in its Dark and Hybrid Books where those using predatory strategies will be unable to enter aggressive

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[45] Quote stuffing occurs when a participant floods the market with orders and cancellations leading to a large number of new best bid/asks potentially lasting microseconds. The objectives of this behaviour is to walk someone through the book in order to leverage rebates, create false mid-points, cause stale prices, and delay market data for others. Quote stuffing only works when the party initiating it can trade against natural flow that is at a speed disadvantage to the HFT. This allows an HFT to dominate the top of book position.

[46] Layering occurs when a marketplace participant places numerous orders at different price points to give an impression of strong buying/selling interest, or to pre-position its orders in support of other strategies. One objective of layering is to drive the price up or down, sell high or buy low respectively, and then get out of the position when the price reverts back to its natural level. Another objective of layering is the pre-positioning of orders either to achieve a trade advantage in conjunction with a momentum-ignition strategy or to benefit from rebates.

[47] Book fading occurs when liquidity disappears after a trade on a specific venue. The objective is to avoid and/or pass on adverse selection when not actually intending to trade at the price originally posted. It is often combined with a layering strategy. It also leverages latency arbitration amongst venues.

[48] Momentum ignition is a strategy whereby an HFT's actions trigger other participants to trade quickly to cause a rapid price move. An HFT can take profit by subsequently trading one or multiple (ladder) pre-positioned orders and trading out afterwards, knowing that the price is likely to revert.

[49] Exploratory trading occurs when a marketplace participant sends in small aggressive orders to obtain private order information to forecast the price impact of predictable demand (private order data is usually available before public order data). The objective is to trade ahead of predictable demand only when it is profitable to do so.

orders, cannot pass on adverse selection. This allows market makers, natural liquidity providers and disciplined HFTs, who know they are protected, to be more comfortable to provide stable and resilient quotes. By doing so in the transparent Hybrid Book, they will counter inappropriate book fading. Aequitas' latency normalization service at smart order routing level, prevents trading strategies that leverage latency differences among different marketplaces.

Momentum ignition. This strategy cannot be implemented in the Hybrid and Dark Books as the segmentation strategy prevents entering active orders to ignite a momentum. Furthermore more disciplined HFT liquidity providers, market makers and natural liquidity providers, who are protected from these orders, will be more comfortable to provide stable and resilient quotes. By doing so in the transparent Hybrid Book, this will curtail signaling strategies on other venues.

Exploratory Trading. The Dark and Hybrid Books do not allow liquidity to be tested because the HFTs are limited to placing passive orders. Since the Hybrid Book is partially lit, it should also help to make exploratory trading on other lit venues unreliable.

Market making and stable liquidity. The ability for HFTs to limit their "market making" activity to large and liquid securities impacts the sustainability of the traditional market maker structure where those market makers have obligations to provide liquidity to less liquid stocks and in bad times (market going against them) as well as good times.[50] It allows the HFTs to generate earnings when profit opportunities are high and inventory risk is low while minimizing cost of capital.

With the quality problems that lit markets are experiencing today due to the behaviours of HFTs, it is critical to come with innovative solutions leveraging dark and lit venues to build a listing and trading environment that will allow investors and issuers to be successful again.

[50] Dean, "Paradigm Shifts & Unintended Consequences: the Death of the Specialist, the Rise of High Frequency Trading, & the Problem of Duty Free Liquidity in Equity Market" (April 2013).

APPENDIX "B" TO AEQUITAS' SUBMISSION

FEATURES	DARK	HYBRID	LIT
Hours	8:00- 17:00	8:00- 17:00	8:00- 17:00
Order types	• Restricted to Non-SME active • Passive (dark orders with no restrictions)	• Restricted to Non-SME active • Passive (no restrictions)	• No restrictions on active or passive • Common order types available on other marketplaces
Features	• Price is based on NBBO • Trades will match at mid - point, one standard trading unit of the NBBO or at the NBBO if at least 50 board lots • Passive (dark orders would be able to specify minimum quantities, specify counterparties to retail or contra-resting, size–up (at option of the party entering the order) • Trade information will be published • No maker/taker fee model	• Price is set based on NBBO • Trades will match at or within the NBBO • Aggregated volume information at NBBO and prices within NBBO will be published (market by price but not market by order) as well as trade information • No maker/taker fee model	• Continuous trading • Full transparency of order and trade information • Maker/taker fee model
Priorities	1. Price 2. Broker Preferencing 3. Market Maker 4. Weighted size/time	1. Price 2. Broker Preferencing 3. Market Maker 4. Weighted size/time	1. Price 2. Broker Preferencing 3. Non-SME 4. Time

APPENDIX B

APPENDIX B

CHARACTERISTICS OF AN EFFICIENT AND EFFECTIVE MARKET INCLUDED IN DARK RULES CONSULTATIONS

The following reflects the text from Joint CSA / IIROC Consultation Paper 23-404 *Dark Pools, Dark Orders, and Other Developments in Market Structure in Canada* published on October 2, 2009 at (2009) 32 OSCB 7877.

"In the view of the CSA and IIROC, any change to the Canadian market should be assessed by considering key characteristics and looking at the impact on the market. The characteristics of an efficient and effective market[1] which are relevant for the discussion in this paper include the concepts of liquidity, transparency, price discovery, fairness, and integrity.

1. Market Liquidity

Liquidity can be defined as the market's capacity to absorb trades from customers' buy and sell orders at, or near, the last sale price of a particular stock. The greater the number of orders and shares available at a particular price, the more liquid the market will be. Some of the characteristics of liquidity are market depth, market breadth, and resiliency. Market depth refers to the number of orders at different prices that line the book. Market breadth is the number of shares that are wanted at a particular price level and the ability to absorb an incoming large order. Resiliency is the ability for a market to attract offsetting orders relatively quickly when order imbalances occur.[2] An additional aspect that is important to assessing liquidity is the number of transactions executed on a marketplace.

2. Visibility/Transparency

Transparency refers to the degree to which there is real-time dissemination of information about orders and trades to the public.[3] In Canada, pre-trade transparency is required when a marketplace displays orders of exchange-traded securities.[4] Post-trade transparency by a marketplace is always required. Order and trade information must be provided to an information processor or an information vendor if an information processor does not exist.[5] Currently in Canada, TSX Inc. is the information processor for equity securities.

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[1] The TSE, in its 1997 Report of the Special Committee on Market Fragmentation: Responding to the Challenge identified a set of characteristics essential to an efficient market. These characteristics were later referred to by the CSA in the background paper entitled "Regulation of Alternative Trading Systems in Canada" published on July 2, 1999 with the initial proposal of the Marketplace Rules.

[2] *Ibid.*, pp. 17-18.

[3] Part 7 of NI 21-101 requires orders to be provided, and subsection 9.1(2) of 21-101CP requires a marketplace that displays orders to provide to an information processor all relevant information regarding orders and trades including details as to volume, symbol, price and time of the order or trade.

[4] No pre-trade transparency is required if order information is only displayed to a marketplace's employees or to persons or companies retained by the marketplace to assist in the operation of the marketplace (subsection 7.1(2) of NI 21-101).

[5] Part 7 of NI 21-101.

3. Price Discovery

Price discovery refers to the process through which the execution price for a trade is established. The discovery of a security's fair market value is derived from two sources: the supply of and demand for the security, which indicate a participant's willingness to transact at a given price, and information about transactions which have actually occurred.

If prices are not transparent to participants, or there is unequal or incomplete information, participants will not be able to make informed decisions. In addition, if participants are not given access to markets where a security trades, they may be discouraged from participating or trading in that security and a less efficient price discovery process may occur.

4. Fairness

Fairness refers to the perception and the reality that all participants are subject to the same rules and conditions and that no one participant or group of participants has an unfair advantage or disadvantage. The "fairness" of a market may relate to fair access to a specific marketplace or the market as a whole, fair access to trading information, or the fair treatment of limit orders. For example, it may be perceived as unfair if all participants are not given access to a specific marketplace, or if information about orders or trades that occur on a marketplace cannot be seen by all participants. The perception of unfairness with respect to the treatment of limit orders has the potential to impact an investor's willingness to participate and contribute to the price discovery process in that market.

5. Integrity of the Market

Integrity of the market is the level of general confidence investors and the general public have in the marketplace as a whole or in a particular marketplace. This confidence is closely associated with investors' perception of fairness.[6] The regulatory environment and the effectiveness of the regulation of that market and its participants also play a role in whether there is confidence in a market.

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[6] TSE Report of the Special Committee on Market Fragmentation: Responding to the Challenge, p. 25