

September 3, 2014

Market Regulation Branch
Ontario Securities Commission
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Re: Application for Recognition of Aequitas Innovations Inc. and Aequitas Neo Exchange Inc. as an Exchange – Notice and Request for Comment

Dear Sirs/Mesdames:

Chi-X Canada ATS Limited (“Chi-X Canada” or “we”) operator of Chi-X Canada ATS and CX2 Canada ATS marketplaces welcomes the opportunity to provide comments on the Ontario Securities Commission (“OSC” or “Commission”) Notice and Request for Comment regarding the Application of Aequitas Innovations Inc. (“Aequitas Innovations”) and Aequitas Neo Exchange Inc. (“Aequitas Neo”) (together “Aequitas”) to be recognized as an exchange (“Application”). We recognize the efforts by OSC Staff (“Staff”) in working with Aequitas through its regulatory application process, which has included a pre-filing and associated request for comment, and now includes formal applications for recognition of Aequitas Innovations Inc. and Aequitas Neo Exchange.

While we recognize that certain modifications have been made to the original trading model proposed by Aequitas (“Original Proposal”),¹ the new model outlined in the Application does not go far enough to address the concerns raised by the Commission and by commenters. The model still includes features such as customer segmentation that in our view will result in a significant change to the market structure we know today – and ultimately lead to one of inferior market structure quality. This, coupled with a lack of transparency from the OSC regarding its position on current marketplace practices that are included in the model, leaves us unclear about what is permitted under today’s existing rule set.

The Commission, in a break from its usual practice, sought comments on certain aspects of the Original Proposal in September 2013. More than 35 stakeholders representing views from dealers, marketplaces and industry committees provided comments. While the Commission has not provided guidance on its position on these issues the Application has been published without a summary of comments from the Original Proposal. We are concerned that the Commission will

¹ http://aequitasinnovations.com/wp-content/themes/discover/docs/Aequitas_OSC_Concept_Paper_ExecSummary_v_Final_Update_200813.pdf

be interpreted as implicitly accepting the Aequitas model and thus that it will establish precedent for further fragmentation and segmentation of the Canadian market.

AN IMPORTANT CROSSROAD THAT WILL DEFINE THE FUTURE OF OUR MARKET

Developments in regulation and trading technology have shaped today's market structure that includes certain characteristics currently under debate, and leading some to reevaluate whether the markets are in need of reform. These topics include whether high frequency trading should be more directly regulated, the impact of dark pools on the price discovery mechanism and how to best address conflicts of interests. In the case where some have called for a complete overhaul of market structure in order to restore it to its primary purpose of raising capital for issuers, we note that most of the issues cited apply to the market structure of the United States and not to that of Canada. As a result of the critical decisions made by the Canadian Securities Administrators ("CSA") to differentiate its rulebook from that of the US, Canada has insulated itself from certain developments and now does not face the same challenges. Examples of issues that are not applicable to Canada because of differences in regulation include:

- Payment for order flow by dealers is not permitted under law;
- Dark liquidity rules have been introduced that require price improvement for orders below a volume threshold and require lit orders to be executed before dark orders on the same venue;
- Trades must be effected in real-time on a marketplace and in the context of the market so that the amount of off-market trading is limited;
- Transparency requirements are in place for all marketplaces that require details to be made available publicly about operations, order type functionality, and other marketplace features;
- Regulatory harmonization between exchanges and ATSS so that consistent rules apply to each type of marketplace when offering similar services;
- Strong controls and other system requirements have been mandated for marketplaces today whereas they are only now being introduced in the United States with the recently proposed Regulation System Compliance and Integrity;
- Marketplaces are required to provide order and trade information to the Information Processor at the same speed that this information is provided to any other market participant; and
- Robust fair and equal access rules are in effect requiring marketplaces to offer their services on a fair and reasonable basis to all participants.

We believe that the OSC is at a crossroad while it contemplates approving the Aequitas proposal and that this decision will define the quality and direction of the Canadian market

going forward. Once the proverbial “genie is out of the bottle,” it will be next to impossible to turn back the clock.

Lessons about how certain key regulatory decisions can result in a slippery slope leading to unintended consequences and over-complexity can be gleaned from the US market. In 2010, the Securities and Exchange Commission (“SEC”) began a holistic review of its market structure with the publication of its Concept Release on Equity Market Structure.² Also at this time, Mary Shapiro the SEC Chairman provided a comprehensive outline of the SEC’s priorities and plans to further strengthen equity market structure.³ This was well received as even those that sought major reforms recognized that piecemeal reforms or regulations through precedent would not lead to better markets in the future. Understanding that other demands have been laid on the SEC such as implementing the requirements of Dodd-Frank Wall Street Reform and Consumer Protection Act, we see the time it has taken to implement these plans is primarily due to the recognition of the interconnectedness of each component part of the US market structure – it is impossible to address one issue of today’s structure without in turn seriously impacting all others.

US regulation permits dark pools to restrict or limit access to selected participants and allows for off exchange payment for order flow. These practices have lead industry critics to question if routing practices comply with best execution requirements. Questions are being raised about the amount of volume trading off exchange and in turn whether or not the integrity of the price formation process has been jeopardized. In order to address the quality of price discovery, the SEC must determine what steps need to be taken to address each contributing factor of the problem. It is no longer possible to look at one issue without seeing how it will affect another.

We believe that the OSC (and CSA) will face similar challenges in the future should it permit any form of **explicit** segmentation to take place. **Understanding this, we believe a decision to approve Aequitas’ proposed model will establish a precedent for other marketplaces to offer similar forms of segmentation and ultimately lead to an inferior ecosystem and more fragmented order flow.**

WHAT IS THE CURRENT POSITION OF THE OSC ON KEY ISSUES?

In our response letter to the RFC, we stated the belief that the rule-making process should be conducted independently of the merits of a commercial offering. The OSC sought comments on several key and controversial issues. Stakeholders (including Chi-X Canada) have yet to hear the view of the Commission on these issues or receive responses to comments submitted. Since this time a formal exchange recognition application has been published with a modified trading model that continues to advocate restricted and unequal access to trading books, which is not

² <http://www.sec.gov/rules/concept/2010/34-61358.pdf>

³ <http://www.sec.gov/news/speech/2010/spch090710mls.htm>

permitted today. Are we to infer that the Commission is comfortable with the proposed Aequitas model? If this is the case, then what is the basis for the policy shift?

We request that the Commission provide public communication on the issues raised in the RFC and in particular with regard to the following questions: Does the CSA agree with what has been currently proposed? Does the Commission believe that today's market structure is failing its intended purpose? Are these views based on statistical analysis or conjecture? What specific guidance can the OSC provide on the application of fair access today?

Realizing the importance of the questions above we ask that formal views are communicated publicly so that marketplaces can re-evaluate their positions and compete equally within the existing rule framework.

Our response is broken down into five major themes from the Application that either raise concern or that we seek clarity from the OSC. Certain questions then follow in Appendix A. These themes are:

- Customer segmentation;
- Complexity;
- Bundled Services;
- Market Making;
- The Application of OPR to Aequitas; and
- The Consolidated Market View and Fair Access.

Major Themes

I. Customer Segmentation

We believe it is essential to ensure that a market supports an ecosystem where different types of order flow, each with its own trading objectives, strategies and time horizon, can interact. By restricting or constraining access or permitting discriminatory access standards across categories of participants the price discovery process is negatively impacted. True prices for securities are best established by all market participants and not a subset of them. We believe that marketplace features should be accessible by all participants on similar terms and conditions. There is a difference between competing commercial models that incentivize participants to seek the services that best meet their trading needs and objectives (the byproduct of healthy competition) and a trading platform that explicitly restricts access to a segment of participants. In addition, explicit segmentation results in the creation of liquidity silos that may negatively impact market integrity and market quality. We also note that the fee reduction conferred on retail flow sent to both the Neo Book and Dark Book result in little benefit to the end investor unless these savings are passed on.

A related concern is effective oversight of the self-certification process of Neo-Traders. Originally proposed to use the short marking exempt regulatory marker (“SME”) as its segmentation tool, Aequitas now proposes to use the definition of a Neo Trader account.⁴ This new definition excludes the same three account characteristics as an SME account with an exception carved out for a facilitation account.

The lack of specificity in this definition could result in either circumventing the definition (therefore qualifying an account to take liquidity from the Neo and Dark Books) or casting too broad a net that will result in unintended accounts qualifying as Neo Trader accounts. There are no metrics around what is considered a market neutral position at the end of the trading day (95 percent is used in the case of the SME). In addition, it is impossible to know if activity across multiple accounts relates to the same trading strategy. As such, two accounts could execute parts of one trading strategy in order for both to qualify as Neo-Trader accounts. Where one account executes the majority of the buy orders and the other executes the majority of sell orders, each can qualify as a Neo Trader while in reality they are part of a single strategy and would not qualify if traded from one account. Without robust oversight of the self-certification process potential abuses of this kind are possible.

We believe that in order to regulate compliance with the self-certification model proposed that IIROC would need to significantly increase its current resource base or place higher demands on existing ones. Given that IIROC operates on a cost recovery basis, funded by its members, this means that the industry will ultimately have to fund these new resources. It is also interesting that since IIROC has moved to a market regulation fee model where certain costs are allocated based on the number of messages and trades generated by each participant that a disproportionate level of resources may be allocated to oversee a new marketplace thus potentially requiring a re-evaluation of its cost recovery methodology.

Segmentation also raises issues with regards to best execution. It is difficult to see how a dealer could justify posting passive order flow on an order book it knows does not provide access to all potential counterparties. In order to do so dealers will have to learn how to make best execution decisions based on a complex and untested model. This adds a level of complexity that may be difficult to manage or result in overly simplistic best execution decisions.

⁴ “Neo Trader™” orders are orders that cannot be entered through a Trader ID that sends orders from:

- an arbitrage account;
- the account of a person with Designated Market Maker obligations; or
- an account for which trading strategies are automated and which generally do not carry net long or short overnight positions (i.e. is non-directional or market neutral);

but may be sent from 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.

Explicit customer segmentation can also raise transparency issues where information is provided to certain participants before it is provided to the Information Processor. The Aequitas Dark Book offers a Size-Up Call feature where a qualifying liquidity providing order can decide to commit further capital at the previous mid-point match or at the closest side of the NBBO if the market has moved. Information about indicated interest and firm orders in the Size-Up call process is limited to only those parties participating in the call. It is further restricted to certain qualifying counterparties permitted to participate. Eligible liquidity providing orders can also select to either interact with both institutional and retail Neo Trader accounts or only retail accounts. We question how an order type that disseminates trade information to only a select group of participants is consistent with the transparency requirements of National Instrument 21-101.

Finally, we question why Aequitas has chosen to place broker-preferencing ahead of Neo Trader Orders in its matching priority and its size-time feature in the Neo Book and Dark Book given the objective to prioritize the needs of Neo-Trader accounts. Recognizing that the model is intended to result in higher quality executions and encourage longer quote lives and larger order sizes by liquidity providers, we fail to understand why Aequitas would use a matching logic that allows proprietary orders from the same firm to match ahead of Neo-Trader orders entered by other dealers. By doing so, investors will be forced to use dealers that control the largest market share in order to realize the benefits of the model. If the objective is to service this community, then its implementation appears to operate in contradiction of this chosen objective.

II. Complexity

Aequitas Neo supports four trading books each with different features and pricing. It also proposes to support two new order types that may be used to post an order on multiple books at the same time. In the case of the National Best Peg Order, this order will be either displayed or hidden based on the security at the discretion of the marketplace. Taken as a whole, the interconnectedness of the four trading books, the unique display features of the Neo Book, the introduction of two new order types, and the proposal to support unique trading sessions such as the call auction in the Dark Book represent a high level of complexity. Given the well-known resource constraints across the industry, in particular at small and medium sized dealers, we question whether the dealer community will benefit equally from the Aequitas model.

At a time when regulators are being scrutinized for enabling the ever increasing complexity of equity markets, Aequitas is proposing to introduce a market model that will support many complex features unfamiliar to Canadian participants. We are supporters of innovation and competition however we believe that consideration should be given to the relationship between a trading model's complexity and the ability for all participants to enjoy the intended benefits offered by the model. Greater complexity requires more education and understanding in order to integrate the model's features into existing trading practices.

Where complexity exists, it is our observation that those who benefit most are sophisticated traders who have the capital resources to understand and capitalize on changes in market microstructure. Given that Aequitas has held itself out to be the champion and protector of the long-term investor, it is ironic that a model designed to protect these interests may result in the opposite outcome.

III. Bundled Services

Under current regulations, trading platforms are required to register and operate as distinct marketplaces. In the case of the launch of CX2 Canada ATS, Chi-X Canada was required by Staff to operate and manage Chi-X Canada and CX2 Canada independently from one another. We therefore filed and continue to update separate Form 21-101F2s, compliance manuals, business continuity plans, operation plans, subscriber manuals, subscriber agreements, vendor agreements and other documents for each market. The stated rationale for Staff's instruction was to ensure that no advantages were given to a subscriber of one market that was derived from being a subscriber of a related market.

Aequitas Neo's market model supports four different trading books: Lit Book, Neo Book, Dark Book and Crossing Book. Although each supports unique features and each have different pricing schedules, the Application represents that *all four books taken together comprise* Aequitas Neo Exchange. This interpretation is further supported by the fact that there is only *one agreement* for members to gain access to all *four trading books*. Additionally, the Aequitas patent application diagrams how the trading books interact with one another and are referred to as "networked" venues.

Given previous guidance, we seek clarity on the OSC's current views on whether an exchange or an ATS can operate separate trading books as one marketplace, or if each trading book must be operated independently from one another. If all four trading books are considered one marketplace, we see several instances where services are bundled together and question whether the application of certain UMIR rules should apply across books. Examples of bundled services are the offering of access to all four books for one membership fee, the functionality of the derived order (see below) and market makers being offered benefits on all four books while only needing to meet explicit obligations on two books (only a general maintenance of a fair and orderly market obligation on Dark Book). An example of a rule that may apply is whether the application of lit priority over dark orders should be applied across multiple books in compliance with UMIR.

Derived Order

OSC guidance on whether a marketplace may operate more than one book also has implications on how we view the Aequitas Neo proposed Derived Order type. Using this order, members are able to enter an order on one book while simultaneously posting the same order on multiple books as lit or dark depending on the venue and by instruction of the user. If the OSC's view is that multiple books may be operated as one single marketplace, then this order type is an example of the leveraging of multiple books. If the OSC does not hold this view then this order type raises fairness issues since the guarantee that the order only fills once implies that the books share information not available to all participants at the same time. Today, Chi-X Canada is not permitted to support an order type on one of its venues that interacts with the other venue for this very reason. Instead, two distinct orders must be entered on each venue and must be managed separately by their end user.

IV. Market Making

As a general principle, we believe that the benefits granted to market makers should be commensurate with the obligations for the securities for which they have responsibility. Although the Application outlines certain market maker obligations at a high level, there is a lack of detail provided for the commitments that market makers must fulfill on each trading book and the benefits conferred on them for fulfilling these obligations. Given this lack of detail, we are not in a position to comment on whether or not an appropriate balance has been struck between the benefits and obligations of the market maker program.

Additionally, we note that the benefits offered to market makers through market making programs referenced in the Application such as BATS' Competitive Liquidity Provider Program ("CLP") and NASDAQs Market Quality Program ("MQP") cannot be assessed unless more specifics are known about how they will apply to Aequitas. In the case of BATS's CLP, compensation is paid to market makers that compete with one another for performance with posting obligations on individual securities. Whereas competition between market makers forms the underlying rationale for the CLP program, there is only one market maker per security in the Aequitas model. What forms the basis for compensation if there is no competition? Additionally, the CLP and MQP are only permitted for ETFs today. They have not been approved for all securities by the SEC and FINRA. Without knowing more about these programs, at this time we are unable to assess their benefits.

V. Application of the Order Protection Rule, Aequitas and the Neo Exchange

There are two considerations related to the Order Protection Rule ("OPR") and the Aequitas Application.

Should the Lit Book be a protected marketplace at the time of launch?

From a policy perspective, we believe that if the Lit Book is launched before the CSA agrees on its final approach to OPR, that the Lit Book should be a protected market. However, from a practical perspective we are concerned about the cost and development work imposed on the trading community by an existing rule that is subject to change. Should proposed amendments to OPR become final, then it is unlikely that Aequitas will qualify as a protected market (as is the case with any new marketplace). As such, we suggest that the OSC postpone the start date for operations until the proposed amendments to OPR become final. By doing so, the industry will not be required to spend the resources to connect to a protected marketplace that may not be protected after OPR is amended only a short time after. We also note that the OSC delayed the intended launch date of CX2 due to considerations of the technology work required by dealers as it coincided with the implementation of the Electronic Trading Rule.

Should the Neo Book be protected?

We do not believe it appropriate for a rule to obligate all participants to access a market while different fees and different service levels (speed bump) are offered to various classes of participants. We also find the request to protect the Neo Book confusing as Aequitas states on page 31 of the Application that, “Aequitas can also achieve its objectives in the Neo Book by applying meaningful disincentives to orders from LST while at the same time subjecting Neo to OPR.” Why would a model that is intended to deny access to certain participants believe it is necessary to then mandate those same participants access the venue? Protecting the Neo Book would be like forcing all business travelers flying to a conference to fly with a carrier who will charge more and often experiences delays. The decision to support or connect to a trading book where not all participants are treated equally should be left with customers and not be driven through a regulatory mandate.

VI. Market Data and Fair Access

In addition to its regulatory application, Aequitas has also utilized other avenues as part of its strategic plan. On December 9, 2013 a Canadian patent application (“Patent”) was filed by Aequitas that became public on June 11, 2014.⁵ The Patent includes a description of a market data product, Consolidated Market Data View (“CMV”) that combines private order messages from a subscriber (“drop copies”) with real-time public information messages from Aequitas. We understand that given this product was not included as part of the Application it is unusual for us

⁵ [http://brevets-patents.ic.gc.ca/opic-cipo/cpd/eng/patent/2835860/summary.html?query=\(aequitas\)&start=1&num=50&type=advanced_search](http://brevets-patents.ic.gc.ca/opic-cipo/cpd/eng/patent/2835860/summary.html?query=(aequitas)&start=1&num=50&type=advanced_search)

to provide comment on it. However, we do not see that another opportunity may present itself in the future and for this reason want to raise certain concerns.

The ownership structure set out in the Application shows that Aequitas Innovations is the holding company for Aequitas Technology Services (“Aequitech”), Aequitas Capital Link Inc. and the Aequitas Neo Exchange. It appears that the CMV will be offered and supported by AequiTech, a vendor. Given that vendors are not regulated by the CSA and that the provision of market data is a marketplace service, we encourage the OSC to require that it be kept apprised of the products’ development and implementation so it can determine whether issues are raised.

We are concerned about the fairness of this product as described in the Patent. In addition to describing the basic idea for the CMV, materials also include the statement “that there may also be agreements between various market participants to permit and facilitate the sharing of data.” Although the details are not provided, it is reasonable to conclude that multiple subscribers who are willing to opt-in will be able to consolidate their drop-copies with real-time market data from Aequitas Neo to create one consolidated view of the market. Should this be the case, we see an advantage for large dealers over small dealers due to economies of scale.

Fairness concerns are raised by the level of service that is made available to market participants. Although all members will be able to use the CMV, the quality of this product (and therefore level of service) will depend on the concentration of order flow managed by each dealer. Given that the large dealers control over 50 percent market share, they will have a more accurate view of the consolidated market than a smaller dealer will. This advantage is accentuated in the case where dealers agree to share drop copies with one another. Dealers with larger market shares will have greater negotiating strength when considering these decisions and there is potential for consortiums to create a market data product that is not available to all participants

We recognize that vendors are not regulated entities. However, given that AequiTech is a subsidiary of Aequitas and is providing marketplace services, we believe that the OSC should be required to approve and oversee the deployment of this product should it be intended to come to market. In this way, assurance will be given that all dealers are treated fair and equally.

Given the importance of the issues raised by the Aequitas model, we would like to thank the OSC for the opportunity to respond to the Application and welcome the opportunity to discuss our submission with Staff.

Sincerely,

Chi-X Canada