

September 27, 2013

Market Regulation Branch
Ontario Securities Commission
20 Queen Street West, 22nd Floor
Toronto, Ontario M5H 3S8
e-mail: marketregulation@osc.gov.on.ca

Re: 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.

Dear Sirs/Mesdames:

Chi-X Canada ATS Limited (“Chi-X Canada” or “we”) welcomes the opportunity to provide comments on the 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. (“Notice”).

We commend the OSC on its thorough review and for requesting public comment on these policy considerations before making a decision on the proposal, however, we believe that it would be beneficial to separate the public policy and commercial debates.

The Aequitas Proposal¹ refers to investors as “traditional investors” consisting of retail and institutional investors. We believe that this definition is overly simplistic and does not recognize the changes that have taken place in the investor community. Market investment is the process of placing capital at risk in the market in order to gain (or lose) from changes in security prices. This may be done over a time horizon as short as a few seconds or minutes or as long as a few months or years. It can be accomplished through different investment vehicles. Investors (both retail and institutional) may place buy and sell orders directly on a market, invest in a fund or have a qualified broker invest on their behalf. With the exponential increase in the speed of trading, many of the high frequency trading strategies (referred to in Appendix C of the Notice) are used by both proprietary firms to generate profit and institutional funds to generate returns for their investors. For this reason we do not agree with the definition of the term “investor” in the Aequitas Proposal, however, to be clear we have included the term “traditional investor” in the same manner that “investor” is used in the Aequitas Proposal.

INTRODUCTION

Aequitas asserts that recent changes in market structure have disabled the market’s ability to continue to fulfill its primary functions of serving investors and facilitating capital raising by issuers. In an attempt to “refocus” the market Aequitas has proposed a new market model, which it believes, will address these concerns. ***Although we understand the commercial rationale for the Aequitas Proposal, we are concerned that a commercial offering is potentially driving significant market structure change.***

Canada’s regulatory framework has been built upon the fundamental principles of protecting market integrity, ensuring an effective price discovery process, and allowing fair and equal access to all participants. If, as Aequitas asserts, there are problems with Canada’s market structure requiring new

¹ The Aequitas Proposal includes, among other things, three trading platforms: Aequitas-Lit, (“A-Lit”), Aequitas-Hybrid (“A-Hybrid”) and Aequitas-Dark (“A-Dark”) (together the “Aequitas Proposal”).

rules, we believe that the CSA is the appropriate party to make such a determination. Unlike the past where policy was developed by reaction to an event or speculations over a future change, regulators are now equipped with tools that enable them to drive policy considerations based on empirical evidence and quantitative metrics. Furthermore, a process _ mandated by securities law – must be followed by the regulator when introducing new regulation. We understand the commercial reasons for Aequitas to drive regulatory change; however, is it not a better approach for the CSA to evaluate each proposed rule change independently of the Aequitas Proposal?

Although the Notice requests comments on a limited number of features of the Aequitas Proposal, given its significance to the future direction of capital markets we have provided general comments, which include information from all Aequitas publications. Our comments are focused on the following themes and questions:

- Although Aequitas represents itself up to be a proponent of competition, its approach to intellectual property runs counter to this position;
- We question why such significant regulatory change is needed to address perceived problems in today’s market structure given the unintended consequence that any new regulation may have;
- We question whether it is appropriate to introduce a model whose complexity will impose significant industry costs;
- We question the use of a regulatory marker for commercial purposes and highlight the operational limitations of using the SME marker to accomplish customer segmentation between traditional investors and other participants;
- We see value in permitting non-listing marketplaces to support market making programs and extending eligibility to DEA clients under supervision of their sponsoring brokers; and

Outside of the scope of the Notice, we commend Aequitas’ efforts to facilitate capital raising for companies that otherwise would not qualify for public listing. In a challenging economic environment where companies are struggling to source funding, relieving these companies from the burden of having to consider a premature IPO to raise capital and from bearing the cost of high listing fees we believe should be acknowledged.

COMPETITION

a) Competition and Intellectual Property

Aequitas claims that the existing Canadian market structure and current exchange practices cater to high frequency traders that profit from short term gains at the expense of investor sand issuers. Aequitas asserts that choice, driven by competition and built on differentiation is acutely needed to remedy this condition. However, their actions in applying for patent protection for many features of their market structure are inconsistent with this stated position.

Chi-X Canada operates on the belief that competition leads to innovation, choice and lower costs for industry. This competition, in turn creates efficiencies, encourages greater market participation and leads to a more competitive capital market. We believe that market forces should be the primary drivers that dictate which service providers are rewarded or penalized for their innovation or lack thereof. The pursuit of a legal constraint on the broad use of marketplace features that effectively prohibits others from adopting and expanding on these features runs contrary to the spirit of competition and threatens to limit the overall quality of trading services. From this perspective, the Aequitas Proposal while held out as an advocate for choice, driven by competition, appears instead to being made in the context of self-interest without regard for the overall market.

Chi-X Canada has shown leadership in innovation while supporting competition by introducing several marketplace features in Canada: dark orders, pegged orders, locked and crossed market prevention; and smart order routing, which later have been adopted by other marketplaces. Without access to these features by other marketplaces, a lower overall quality of trading services for market participants would exist today. In the case of locked and crossed market prevention, such a constraint would have resulted in marketplaces not being able to meet their obligation under the Order Protection Rule (OPR) as the use of a re-pricing mechanism would not have been available as a solution. This is important to note as it is impossible to predict what features introduced today may be needed for compliance or remain in the commercial arena.

WHY IS THERE NEED FOR SIGNIFICANT REGULATORY REFORM?

The implementation of regulatory reform risks unintended consequences, which increase proportionately with the significance of the change. Several features of the Aequitas Proposal require significant regulatory change in order for Aequitas to operate – particularly fair access and customer segmentation. As evidenced by the Notice, the consideration of restricting access to one side of the market by certain participants represents a significant deviation from current rules.

The Aequitas Proposal is built upon the assertion that problems exist in current market structure. While today's market structure has room for improvement we are concerned about the impact of the regulatory changes required by the model Aequitas is presenting as the solution. Additionally, we are unclear why a solution cannot be achieved within today's existing regulatory framework. We note that the compendium of research on the impact of recent market structure developments (including the emergence of high frequency traders) provides conflicting findings on whether or not traditional institutional investors are being harmed by current market structure. Much of the research indicates that retail investors have benefited from current market structure. Furthermore, Aequitas' claim that predatory trading behavior exists in the market today is a critical reflection on existing market regulation conducted by IIROC. If this claim is correct, amendments need to be made to UMIR 2.2 in order to include what is generically referred to as "predatory behavior" or greater supervision and enforcement action is needed to eliminate this behavior from the market. In either case, we believe the determination whether or not this assertion has merit should be made by IIROC and not by a for profit entity.

The Aequitas Proposal implicitly takes the position that customer segmentation and fair access cannot coexist. There are other ways to offer solutions to segments of participants without restricting access to other participants as Aequitas proposes. An example is the movement by marketplaces to employ inverted maker-taker pricing schedules to lower costs for active investors. Although offering an economic incentive to a certain segment of customers based on their trading behavior, this model also offers the same benefit to any participant that removes liquidity from the market.

Other marketplaces are attempting to address perceived limitations of market structure within the existing regulatory framework. For example, US based IEX Group ("IEX") is intentionally introducing minimum latency in its market by using different data centers for order entry and its matching engine. Additionally, although not subject to fair access rules as a registered ATS, all participants are eligible to trade on IEX.

A healthy market ecosystem consists of participants with different trading objectives and different trading strategies. Restricting certain participants' access to pools of liquidity will lead to the creation of "silos." If approved in its current form the Aequitas Proposal will not only add complexity and create customer segmentation, but will lead to further complexity and segmentation as other market operators will

introduce similar models to the market. Instead of making it easier for investors to source liquidity this complex and disparate market structure will result making it harder to achieve trading objectives.

Information leakage

Unlike the needs of retail investors whose execution considerations tend to be comprised of time and price, large institutional investors must balance the consideration of immediacy of execution against potential market impact and information leakage because the size of their orders can significantly move the market. Limiting the ability to remove liquidity in the A-Hybrid and A-Dark books to traditional investors, will make it easier to identify large institutional orders. Any small order that appears to be part of a larger order will be perceived as a large institutional order. Consequently, liquidity provision will dry up and instead participants will take positions in the same direction as the “perceived” large order. Ironically, the attempt to protect traditional investors through restricted access will lead to new challenges for investment performance.

Given the significance of regulatory changes the Aequitas Proposal requires we question whether the risk of unintended consequences is commensurate with the purported rewards.

COMPLEXITY LEADING TO HIGHER COSTS FOR THE INDUSTRY

The complexity of the Aequitas model of operating three separate and distinct markets each with its own set of rules stands to create industry confusion and substantially increase costs. In a period when regulatory costs are rising and there is a call for simplifying market infrastructure, we are conscious of the significant investment required of the industry if Aequitas is brought to market.

Today’s multiple marketplace environment has reached a stage where participants are connected to each marketplace and smart order routers have been developed to route orders to the best market regardless of different protocols being used by different marketplaces. That said, the complexity of the Aequitas Proposal highlights the significant investment required by dealers, vendors and marketplaces to incorporate many of Aequitas’ unique features into their existing technologies. These include:

- Challenges for market data vendors and consumers considering how to consume Aequitas’ market data product if it includes market data from A-Hybrid, particularly in their calculation of the NBBO used for regulatory compliance;
- Challenges for dealers, vendors and marketplaces to exclude A-Hybrid to prevent the appearance of a locked or crossed market;
- Considerations for order routing for a lit venue that is not protected under OPR;
- Development work to exclude orders with SME markers; and

IMPLEMENTATION ISSUES AROUND THE SME MARKER

The SME marker was introduced by IROC to relieve the regulatory burden of accurately marking short sales by participants who generate large numbers of orders in short periods thereby making it difficult to know whether a true long or short position is held at any one time. Furthermore, by having these accounts mark their orders as SME, a more accurate picture of true short selling activity in the market could be ascertained for monitoring purposes.

A-Hybrid and A-Dark propose to restrict participants other than investors from removing liquidity by using the SME marker. If, as proposed, all SME orders have restricted access, an economic incentive is created for participants to shift their behavior in order to benefit from access to A-Hybrid and A-Dark.

The definition of a SME account does not refer to professional accounts. Instead, a SME account is characterized by computer-generated orders for trading strategies that limit risk by not taking overnight positions. An SME account ends the day with a neutral position in 95% of the names its trades. By making a decision to take a marginal amount of additional exposure overnight (for example 6%, and consequently 94% neutral) an account would fall outside the SME definition and gain access to Aequitas' A-Hybrid and A-Dark books. Thus, the objective to limit access to retail and institutional accounts using the SME fails. The definition of an SME also includes arbitrageurs that create pricing efficiencies between related securities. By excluding arbitrageurs on A-Hybrid and A-Dark, pricing differences will be created that are unable to be aligned with the securities true value.

MARKET MAKING

We do not understand why today a marketplace other than a listings exchange is not permitted to support a market making program on securities listed on another exchange (and note that no such restriction can be found in NI 21-101 or NI 23-101). With the advent of multiple marketplaces, investors now trade exchange listed securities on multiple venues. Routing decisions are based on differentiated product offerings and pricing schedules, irrespective of the exchange where a security is listed. Highlighted by the US flash crash of May 6, 2010, a need exists for committed liquidity provision across multiple venues that trade the same security. Permitting non-listing marketplaces to support their own programs will be a step to provide more market making commitments supported on more marketplaces. Continuing to restrict marketplaces from supporting their own programs deprives the market of a valuable service.

We support Aequitas' proposal to extend the eligibility to DEA clients to act as market makers on the condition that their sponsoring broker accepts responsibility for their trading behavior. If a participant is eligible to be a DEA clients under the Electronic Trading Rule ("ETR") we do not see the difference between entering orders to fulfill market making obligations and other order flow entered on the market. The ETR regime requires dealers to have pre-trade controls that include, among other things, controls to ensure compliance with marketplace and regulatory requirements. Dealers are responsible for orders entered by their clients and obligations are set out in mandated legal agreements.

The Notice sets out the responsibilities of the market maker as maintaining an orderly market, fulfilling odd-lot commitments and acting as a gatekeeper. All three of these responsibilities are now automated. The responsibility to maintain a fair and orderly market is achieved by certain electronic market makers who have taken traditional strategies and made them computer generated. UMIR has been amended to permit auto-execution for odd lot orders on a marketplace recognizing the automation of these obligations held by traditional market makers. Finally, gatekeeper responsibilities are almost exclusively fulfilled on a post-trade basis. Because of the speed at which orders are generated and trades occur, compliance and surveillance systems can now only respond to alerts for potential infractions after a trade occurs. Not only does this make the traditional market maker gatekeeper function obsolete but also it introduces an opportunity for two participants to fulfill gatekeeper roles – compliance staff working for an eligible DEA client and compliance staff working at the DEA clients sponsoring dealer.

Participants have adapted to technology and now unofficially serve in the role of market maker. ETR sets out detailed requirements for DEA client eligibility including the requirement for contracts to be entered into by each DEA client and its sponsoring dealer. If these participants are willing to commit to market maker obligations, we do not see added risk in permitting them to act as market makers and ultimately serving to support fair and orderly trading.

PREFERENTIAL ROUTING AND PRICING

The Aequitas Proposal may present an incentive for uncompetitive practices including preferential order routing and pricing by dealers and buy-side firms that control a significant portion of Canadian marketplace order flow. We submit that it is appropriate that similar terms and conditions as were applied in the Maple Group purchase of the TMX Group be applied to the Aequitas Exchange and its shareholders if the Aequitas Proposal is approved.

CONCLUSION

Although we understand the rationale for the Aequitas Proposal and see merits in a number of the proposed elements, we question why such significant regulatory change is needed to address perceived limitations in today's market structure and believe it would be beneficial to separate the public policy and commercial debates.

We thank you for the opportunity to comment on the Notice and welcome the opportunity to discuss our submissions further.

Sincerely,

Chi-X Canada