



VIA ELECTRONIC MAIL

September 27, 2013

Market Regulation Branch  
Ontario Securities Commission  
20 Queen Street west, 22<sup>nd</sup> Floor  
Toronto, ON M5H 3S8

**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**

CNSX Markets Inc. thanks staff of the Market Regulation Branch of the Ontario Securities Commission for the opportunity to address a number of issues raised by the proposed structure of the trading services to be operated by Aequitas Innovations Inc. ("Aequitas").

We understand, without necessarily sharing, many of the concerns about current market structure in Canada that Aequitas is seeking to address with its new services. There is always a tension amongst market participants, probably dating back to the earliest Mesopotamian human commercial interactions if not earlier, concerning the motives, strategies, conduct and principles employed by one's trading counterparties. With the varying objectives of the parties in modern public equity markets, it is to be expected that competing market operators, under the guise of innovation, will seek to address these differences with market structures designed to "protect" groups of like-minded participants from "bad" or "predatory" practices used by parties perceived to be better informed or better equipped than themselves. For reasons that will be discussed, CNSX Markets believes that these attempts to isolate different market participants are not in the public interest, and should not be permitted.

The policies underlying our equity markets are intended to promote price discovery through the interaction of order flow from all of its varied sources. Supporting efficient price discovery is the key function of a secondary market:

- It is the engine that best supports capital allocation among competing public companies. It also reduces the cost of capital for these enterprises by fostering liquidity and confidence in the operation of the markets. Reducing the cost of capital for deserving companies promotes their growth and provides broad economic benefits such as employment and wealth creation.
- Price discovery is best achieved by encouraging the broadest possible diversity of interests and objectives to interact in a common trading process. This overriding principle has informed our market policy that encourages long term investors (be they retail or institutional, small and large) to interact with market makers (of different stripes), arbitrageurs (cross-border/currency, cash/derivatives, cash/ETF, statistical), quantitative strategists, day traders, momentum investors, short sellers and all the rest. In this way, we collectively ensure that the reported last sale price reflects **all** of the available information and prevailing sentiment for a particular security.

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The need to protect the integrity of the price discovery process is at the root of many of the issues identified by OSC staff in its review of the Aequitas proposal. In particular, CNSX Markets shares the concerns expressed by staff in respect of the challenges posed by the Hybrid market facility to the principles of fair access to markets. Seeking “protected” status under the Order Protection Rule (“OPR”) on the one hand, while seeking to limit the participation rights of certain market actors on the other, also gives rise to the significant operational issues identified by staff in creating potential trade throughs, and the opportunity for locked and crossed market conditions.

CNSX Markets submits that as a result of these concerns, orders on the Hybrid market facility as proposed should not be afforded protected status under OPR.

Turning to the specific questions from the Request for Comment:

**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?**

CNSX Markets believes that attempts to limit the application of OPR are motivated by parties whose business models have come under the greatest pressure as a result of the changes in market structure over the last six to seven years. The cost burden of these changes has fallen most heavily on large investment dealers. Agency order flow, with tightening spreads in the market, is predominantly liquidity taking; meaning that the dealer is paying “take” fees to the marketplaces a high percentage of the time. These dealers also have diverse trading operations, each of which may require unique connectivity to the trading and market data services provided by each protected marketplace. The costs of integrating these new marketplaces for an individual dealer are likely material and do not appear to have been offset by new revenue opportunities for these dealers. That said the narrowing of spreads in the most liquid stocks in Canada alone has resulted in savings to investors that dwarf the integration costs undertaken by the industry. CNSX Markets strongly believes that protecting displayed orders on visible markets has given rise to a more efficient and competitive secondary market in Canada.

**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?**

We do not believe that OPR should apply to any of the orders booked on Hybrid. The orders are not displayed in the same manner as orders on other protected venues and, as staff points out in the discussion part of the comment request, could lead to significant programming and process challenges for other marketplaces and dealers looking to meet their OPR and best execution obligations. Again, as discussed by staff, granting OPR protection to Hybrid orders could lead to numerous instances of locked and crossed markets. We submit that this state could be deeply harmful to investor and participant confidence in Canada’s secondary market trading system.

**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?**

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We do not support the granting of protected status to Hybrid orders. This would mean that orders booked on the Hybrid facility would be treated the same as orders booked on other dark pool facilities: potentially relevant for the purposes of a dealer's best execution obligation, but not relevant for the purposes of a marketplace's OPR obligation.

**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?**

CNSX Markets believes that the issue can be resolved on the basis of whether Hybrid is a protected market under OPR. If Hybrid is characterized as a "dark" market, and regulated as such, then there is no issue as to the inclusion of Hybrid "quotes" for the purposes of the price improvement requirements in place for the remaining dark markets. This question illustrates just one of the many operational complexities that would arise if the Hybrid market is afforded protected status under OPR.

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

It seems abundantly clear that if a visible marketplace is accorded protected status for the purposes of OPR, then fair access requirements must be strictly applied. Otherwise the integration issues discussed by staff become problematic; we also run the risk of compromising the integrity of the price discovery process across the different marketplace offerings.

**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?**

For the reasons discussed in the responses to the preceding questions, we believe that restricting access to the best displayed price would lead to practical integration issues, and would have the effect of eroding confidence in the integrity of market processes. The dividing line is clearly whether or not orders are protected under OPR, and in that stance we give market operators a clear choice: if there are no restrictions on access, then better priced bids and offers may be eligible for protection; if the operator seeks to restrict access to the book on any basis, then order protection should not be available.

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

No. As identified by staff, restricting access to Hybrid will lead to a number of practical integration issues, and complicate the workflow to enforce OPR across the other protected marketplaces.

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

Use of the SME marker is a clever way to restrict access to components of its service offering, but is undoubtedly over-wide in its application. While the parties using the strategies criticized by Aequitas are highly likely to be SME accounts, a large number of SME accounts would not (because of the nature of their trading objectives) be guilty of the predatory practices that are said to be restricted under the Aequitas approach. The correct approach to the issue is to deny the Hybrid market protected status, and provide the operators of the exchange with the ability to pick and choose amongst market participants targeted in their two dark books.

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

Although market participants have a long history of ambivalence towards the role of market making, it is accepted wisdom that market makers can improve execution quality and reduce volatility by overcoming the temporal distortion issues in matching “natural” order flow. The debate has always been over the means and quantum of compensation or other advantages enjoyed by the market makers to induce them to provide consistent two-sided markets in their stocks of responsibility. Maker/taker inducements, for example, appear to have resulted in an excess of market maker intermediation in a small number of highly liquid stocks, and provided little if any benefit to the remaining large majority of listed companies.

Exchanges are currently permitting arrangements whereby the issuer itself enters into a payment plan designed to compensate a market maker for ensuring an orderly market in the issuer’s stock. Such arrangements are disclosed to the market, and the market maker’s performance is monitored by the exchange to ensure that their obligations are being met for the duration of their engagement.

Yet another model, dating back to the New York Stock Exchange and Toronto Stock Exchange trading floors, gives matching priority to “specialists” and “responsible registered traders” respectively in return for the trader assuming market making responsibilities in specific stocks. This model has been criticized by a number of commentators over the years as tending to over-compensate the market maker for liquid stocks and under-compensating market makers in more thinly-traded stocks. In the TSE example, when spreads began their decline with the introduction of decimalized pricing, and market maker profitability began to drop significantly, we saw a large number of illiquid stocks “orphaned” by the market making community. We are likely to see a repeat on Aequitas: market makers will scramble for assignments in highly liquid stocks (where the value of further intermediation is questionable), and an absence of market making (where increased intermediation is desirable) for the vast majority of the remaining listed stocks.

There is also the concern, famously expressed by NYSE Euronext CEO Duncan Niederauer when he was running the electronic execution business for Goldman Sachs, that he didn’t want “five guys named Vinnie” handling his orders prior to execution. Instead, Mr. Niederauer and others advocated a transparent price/time priority matching system that rewarded the first order at each price level regardless of its origin. Moving

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to this model, in which the playing field is leveled for all participants, arguably paved the way for the influx of technically sophisticated high frequency trading firms to pursue market making strategies in the liquid stocks. It is possible that the operators of Aequitas are actually trying to turn the clock back by re-instituting a modified form of specialist's privileges: by reducing the transparency and predictability of the execution process they may discourage participation by specific parties (HFT's?) in the Aequitas trading services.

CNSX Markets is of the view that this lack of transparency over the compensation and effectiveness of the market maker's activity could well be detrimental to retail and institutional investors' confidence in the system. If market makers are to be compensated, the level of that compensation should be disclosed to the broader community of market participants and designed to promote improved market quality where it is most needed.

**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?**

Our concerns about the market making model proposed by Aequitas are summarized in the answer to the previous question. Any advantages accruing to the market maker which are not transparent as to their effect (such as participation benefits in the dark pool and Hybrid books) detract from the transparency of our trade execution processes and are not in the public interest.

**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?**

CNSX Markets agrees with the Aequitas proposal to extend market making privileges for securities not listed on Aequitas. As the operator of the first continuous auction market service to offer a competitive alternative to the incumbent exchanges in Canada (Pure Trading), we know first-hand how difficult it is to attract passive and active order flow away from established channels. Implementing a formal market making programme to ensure a competitive two-sided quote is one means of attempting to overcome the enormous advantages enjoyed by the TMX Group exchanges. In the present market condition, bettering the bid or offer is often the only way for a competitor market to draw order flow out of the systems operated by the TMX Group:

- Many dealers have, for reasons of cost, complexity and regulatory concerns, elected to use the TMX Group order routing solution. The current solution does not permit the dealer entering the order to preference any competing market ahead of a facility operated by the TMX Group exchanges. In other words, the only way that an order routed by the TMX gets to an away market is if the away market is showing a better price. Lower execution fees, greater size or other benefits are ignored if the bid/offer is the same as that represented on one of the TMX books. In the interests of competition, non-TMX Group exchanges need to be able to find ways of encouraging aggressive quoting behaviour at reasonable cost.

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- Many market participants have observed that there is “over intermediation” on the liquid stocks, and a notable lack of participation by market intermediaries in mid- and small-cap stocks in the current environment. To encourage better quality markets in stocks outside the S&P/TSX Composite Index, exchanges should be permitted to establish market making programmes. The impact and consequences of these initiatives should be monitored by the marketplace and the regulators to deal with any unintentional consequences, and to weigh the potential benefits (tighter spreads, increased turnover) against the cost of the inducements provided to the intermediaries on a periodic basis.

**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?**

The only practical way to avoid unfairness is to require that parties with market making privileges and obligations are required to be members in good standing of IIROC. While many DEA clients have the requisite trading skills and supporting technology infrastructure to function as responsible market makers (some potential candidates are amongst the most skilled trading firms in the world), a wealth of unintended consequences can be imagined if DEA clients are eligible for appointment:

- Jurisdictional questions might arise over the conduct of non-IIROC dealers in their market making capacity: the application of UMIR would be one step removed from the non-dealer trading firm. Buy-side firms have historically resisted the application of UMIR to their trading activity on the basis that UMIR compliance was the responsibility of the dealer sponsoring their activity in the markets, and that they were answerable to another regulator for their conduct. Similarly, if non-Canadian resident DEA client firms were permitted to obtain market making privileges, international jurisdictional questions could arise? Would FINRA or the FSA have the ability or appetite to effectively enforce UMIR? We do not believe that it is in the public interest to create a setting where a foreign regulatory entity is called upon to enforce Canadian rules of trading conduct.
- Costs. It would likely be more cost effective to carry out the market making function in an entity not affiliated with an IIROC member, since a dealer would be responsible for the direct IIROC fees in connection with the trading activity, and also responsible for the compliance costs associated with their client’s market making functions. There is no guarantee that these costs would be passed along to the DEA client directly. Encouraging the market making function to occur away from the IIROC dealer would, for the reasons cited above, not be good public policy.

**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?**

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As discussed above

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

As we have discussed, and as identified by staff in their background comment and analysis of the Hybrid proposal, there are serious practical concerns related to the appropriate integration of the Hybrid book into the existing multi-market continuous auction market system. Trade throughs and locked/crossed market conditions appear to be a certain result. We believe that all of these factors would not inspire any confidence in the quality and integrity of the markets as a whole. Presumably, if Hybrid's consolidated best bids and offers are accorded protected status, other market operators may be encouraged to implement similar services that combine features of dark pools and lit market to the detriment of transparency and predictability of execution. One would project that understanding a dealer's best execution obligations, already a complicated task, would become that much more difficult in the event that Hybrid and similarly structured venues became a feature of the market landscape.

**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.**

The evolution of market policy in Canada has consistently been guided by the need to protect the integrity of the price discovery process. The risks identified to the process clearly outweigh any real or projected benefit to market participants:

- Increased incidence of trade throughs
- Increased incidence of locked and crossed markets
- Lack of clarity over the consolidated "best bid/offer": where is it and how much is there?
- Added complexity to the design and operation of smart order routing systems
- Added complexity to transaction cost analysis
- Increased difficulty in analyzing best execution opportunities and results
- Potential reduction in market making activity across all venues, due to increased complexity and lack of predictability in the execution process.

All of these concerns will reduce confidence in our 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?**

As discussed in a number of our responses to the specific questions, we do not support the implementation of Hybrid as a protected market under OPR under any circumstances. A pilot programme, while superficially attractive, is not a practical solution: significant programming and integration work would have to be conducted by a number of parties (exchanges, dealers and access vendors) to modify their order routing technologies to accommodate the lack of transparency in the Hybrid order book. As



stated above, the operators of Aequitas should be called upon to make a choice: restrict access to the system and operate the Hybrid facility as proposed as a dark pool, or modify the transparency of the order book and access rules and operate as a protected facility. There should be no middle ground.

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?**

As a market operator, CNSX Markets will not presume to advise our colleagues at Aequitas on a possible re-design of their services.

We again thank staff of the Ontario Securities Commission for the opportunity to comment on the issues raised by the Aequitas application. We are available to respond to any questions that may arise as a result of this, and other, comments received.

Respectfully submitted,

A handwritten signature in blue ink, appearing to read "Richard Carleton".

Richard Carleton  
Chief Executive Officer  
CNSX Markets Inc.