BMO Capital Markets

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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

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

RE: **COMMENT LETTER ON PROPOSED STRUCTURE OF TRADING FACILITIES FOR A NEW EXCHANGE PROPOSED TO BE ESTABLISHED BY AEQUITAS INNOVATIONS INC.**

BMO Nesbitt Burns Inc. (BMO) welcomes the opportunity to provide comments on the OSC's notice regarding the new exchange proposed by Aequitas Innovations Inc. (Aequitas). BMO appreciates the efforts made by the OSC to understand the concerns raised around the new models proposed by Aequitas and for taking the time to solicit feedback from marketplace participants.

As a general comment, BMO is supportive of marketplace and regulatory initiatives that focus on increasing competition, innovation, and competitiveness in the Canadian marketplace. We believe these are important and fundamental characteristics of a thriving marketplace and we encourage the efforts made by Aequitas and the regulators to this end.

We would like to start by making a few comments on Aequitas' proposals and highlight what intrigued us.

Firstly, it is refreshing to see a marketplace proposal that challenges the status quo and tries to compete on verticals that cater to the entire marketplace instead of a narrow band of non-captive clients. The proposals consider unique ways of addressing various issues affecting the Canadian marketplace and do not focus on competing solely on price permutations or faster trading engines.

Dark: Aequitas' proposal for the Dark book is not dissimilar from existing dark pools other than segmenting and restricting active flow from SME participants. This sort of dark pool has been tried before with Alpha Intraspread (albeit with slightly different segmentation parameters).

Hybrid: While an interesting and innovative idea, we are unclear on the overall benefit of Hybrid marketplace and question the problem that Hybrid market is trying to solve by restricting all active SME flow. TSX, in their discussions with the street, have stated that active SME orders only represent 7.6% of TSX's total volume. We believe the vast majority of this flow relates to hedging trades for ETF/interlisted arbitrage and that the actual 'predatory' HFT strategies are a small fraction of the 7.6%.

We question whether the net is being cast too wide to restrict good HFT strategies (that link markets) in order to address the 'predatory' ones? And at what cost (both in terms of dollars and complexity) to the street? We would welcome more marketplace stats to be made public around active/passive SME orders to better understand the nature and scope of the flow that Hybrid looks to restrict.

Lit: In our view, the most interesting concept of the Aequitas proposal is the preferencing of non-SME orders on the passive side in the Lit book. This speaks to the fundamentals of trading in that it gives priority to directional natural investors and places intermediaries at the back of the queue. In addition, this also reconciles the benefits that the intermediaries provide by letting them earn their rebates in situations where there is no 'natural' or non-SME order in the book. We would encourage regulators to promote this concept further to better align the maker/taker fees with value creation instead of encouraging unnecessary intermediation.

The statistics also indicate that the passive crowding out is a much bigger issue than the active momentum HFT strategies that Hybrid market is trying to restrict. IIROC's HOT study estimates that HFT flow represents 22% of volume, 32% of value and 42% of all trades in Canada with the vast majority of this being predominantly passive (it is estimated that these strategies get paid ~$60mm in rebates annually). This creates a severe crowding-out effect and leads to unnecessary intermediation, which is consistent with any natural participants experience in trading a stock.

We do share concerns with the street that all books, due to their nature of segmentation, have information leakage issues. Having said that, we believe most of these can be resolved by making minor adjustments to the proposals (eg Lit can publish order book by price in order to avoid information leakage of non-SME orders getting priority; Hybrid/Dark can allow mid-point matching or anonymous trades to prevent directional leakage issues for non-SME orders).

The following section includes our comments on the key aspects of the Proposed Trading Structure:

A. Segmentation of order flow

Segmentation of order flow brings about legitimate concerns around fair access and OPR which are addressed below.

One additional concern we would like to highlight under this section is information leakage as it pertains to the proposed Aequitas rules. Reading the tape on marketplaces that segment flow can provide insight into the type/direction of participant based on whether they did/didn't execute. This should be addressed by Aequitas in their proposal as they refine it further.

Aequitas is not requesting protected status for their Hybrid book which should result in market forces determining their success/failure. Hybrid seeks to succeed on the merit of its offering rather than protected status vis-à-vis OPR which is a positive sign in our view.

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

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?**

OPR should be applied to all visible marketplaces that do not segment participants. Having said that, OPR should be reevaluated in the broader context of the value marketplaces add to the eco system in order to be granted this privilege. One suggestion would be to revoke OPR for marketplaces that fail to achieve critical minimum thresholds after a defined period of operation. Best execution principles, while not prescriptive, would still ensure that fiduciary responsibilities to clients are upheld.

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?**

OPR should not apply to Hybrid in its current proposed state. OPR should be an all-or-none protection granted to a marketplace and not be based on the type of order within the marketplace. Granular application of OPR on an order level will lead to unnecessary confusion and reduce overall investor confidence in Canadian marketplaces.

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?**

Hybrid quotes should not contribute to NBBO as they are not accessible to all participants. While it's understandable that users can build out their own NBBO based on their requirements, this can get exceedingly complicated as marketplaces set different segmentation rules resulting in multiple permutations of the NBBO. Developing and consuming multiple variations of NBBO will add a significant cost to build out technology and more importantly will add to confusion around visibility of the tradeable quote.

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?**

As stated in response to Q3, we do not believe that Hybrid quotes should contribute to the NBBO. Therefore, to avoid complex and confusing permutations on how dark pool price improvements are calculated, we suggest using the away NBBO quote under all circumstances (regardless of whether OPR applies or not).

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

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

Fair access should be left up to the marketplace to determine if they want to segment participants based on some criteria as this can lead to some interesting innovations. However, if a marketplace decides to segment or restrict fair access to participants, then that marketplace should not be granted OPR privileges and their quote should not be counted towards the NBBO.

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?**

Visible marketplaces today already have varying degrees of 'fair access' although not in the regulatory sense of the definition. Natural participants typically have layers of redundancy, checks and balances that the typical HFT participant does not and as a result is already at a speed disadvantage in accessing liquidity in the markets. This is not a good thing and we welcome any innovation that restores the balance of fair access.

In the regulatory sense of fair access, please see our response to Q5.

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

In the context of current rules and given that Hybrid proposes to have displayed quotes and could be considered a visible market, the application of fair access requirements does not seem to be consistent.

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

We will address the two separate applications of the SME marker in Aequitas' proposal individually:

1) Dark/Hybrid: SME orders on Dark/Hybrid cannot be active – We do not believe the SME marker is an appropriate proxy in this situation as it bundles arbitrage-type strategies that link markets (ie ETF/interlisted arbitrage) with 'predatory' HFT strategies. Furthermore, based on the numbers published by TSX, only 7.6% of total volume are active SME orders and we believe the vast majority of these are arbitrage related.

2) Lit: Non-SME orders take priority on passive side – The application of SME vs non-SME in this scenario is an appropriate proxy for providing priority to 'natural' orders over intermediaries. The passive crowding-out of natural orders is a very real concern and increased disintermediation in the market has made it incredibly difficult for natural participants to trade at the quote.

It is also clear after our discussions with market participants that there continues to be a lot of confusion around the SME marker and its usage. We would like to see a tighter definition and better policing of this regulatory marker should it be used differently than its original intent and in particular by any marketplace for segmenting flow. A good starting point would be the IIROC HOT study as the SME marker should overlap largely with the same constituents/criteria identified as HOT.

B. Aequitas market making program

1. Market maker priority

It is difficult to comment on the effects of the market making priority without getting additional details on Aequitas' proposal. As such, we would like to see further details on how Aequitas intends to balance market maker privileges with meaningful obligations. In general, we would encourage that the obligations are at the very least rules based instead of subjective guidelines in order to instill confidence in the program.

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

It is understandable to provide benefits to market makers to compensate for their market making obligations. In theory market quality should improve if the obligations enforced are meaningful (eg provide liquidity when needed on illiquid securities; stabilize prices in periods of volatility etc)

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?

Yes, it is reasonable to provide benefits in Dark/Hybrid even though obligations are limited to the Lit book. Since Dark/Hybrid are not protected books, participants are free to go elsewhere if the benefits outweigh the obligations.

We would suggest that priority on Dark/Hybrid should not be exclusive and be shared with other participants in the book (similar to the old MGF model). Giving market makers full priority after price and broker provides little incentive for market makers to tighten spreads knowing they have priority at top of book. Competition will also be discouraged to improve markets knowing they will lose in a tie. To compensate for this adjustment, market makers could get priority over SME orders in Lit (but still behind non-SME).

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?

Yes, in order to maintain a healthy market, Aequitas should provide benefits to market makers for all securities trading on their marketplace regardless of original listing.

2. DEA clients as market makers

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?**

DEA clients who would want to engage in market making activity are typically US HFTs and given their expertise in this area, they would definitely provide tighter markets. However, the concern we have in allowing DEA clients to become designated market makers is the accessibility of the end market maker. As a DEA client, their identity is concealed from the broader market and they are one step removed from market participants. The sponsoring IIROC member could also be more concerned about catering to and protecting their DEA client than the obligations to the marketplace. In contrast to this, the old TSX RT model made it relatively easy for market participants to reach out to RTs directly on their designated securities.

Even if DEA clients are allowed to act as market makers (and we have our reservations about this as indicated above), they should only be permitted to do so if the sponsoring IIROC member is deemed to be the official market maker instead of the underlying DEA client. The sponsoring IIROC member should then be held accountable for monitoring and ensuring that responsibilities/obligations are being met by any sponsored DEA market maker (similar to how DEA clients are required to be monitored for other IIROC rules). This arrangement also creates a fair playing field since a DEA market maker cannot utilize multiple broker numbers and is held to the same standard as any IIROC member looking to become a market maker.

We do not believe that being a member of an SRO outside of Canada warrants any exemption on market making duties in the Canadian marketplace. Different SROs will have different regulatory standards and might not be monitoring Canadian markets with the same vigilance as local regulators.

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?**

As mentioned in our response to Q12, we have concerns around DEA market makers being a step removed from market participants and as a result, we would prefer to see them as members of IIROC to identify their trades and be subject to marketplace and regulatory oversight.

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

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

We have a few concerns around the Hybrid/Dark market as it relates to information leakage. Reading the tape on Hybrid/Dark can provide insight into the type/direction of participant based on whether they did/didn't execute. This can be resolved by changing the rules slightly but as it stands, there is potential for information leakage to the market.

The added complexity that Hybrid adds to the market microstructure needs to be justified by a clear cut benefit that is well defined. We fear there could be unforeseen consequences of added complexity that are exploited by a handful of participants to the detriment of the wider marketplace. In addition, having an esoteric market structure could potentially turn off international investors on the fringe.

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.

We are still unclear on the overall benefit of Hybrid. While an interesting and innovative idea, we are unclear on the overall benefit of Hybrid marketplace and question the problem that Hybrid market is trying to solve by restricting all active SME flow. TSX, in their discussions with the street, have stated that active SME orders only represent 7.6% of TSX's total volume. We believe the vast majority of this flow relates to hedging trades for ETF/interlisted arbitrage and that the actual 'predatory' HFT strategies are a small fraction of the 7.6%. We question whether the net is being cast too wide to restrict good HFT strategies (that link markets) in order to address the 'predatory' ones?

D. Hybrid as a visible market

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 reevaluated based upon some criteria or threshold? What type of criteria or threshold might be appropriate to minimize potential negative impact?**

It is less than ideal to have a pilot program functioning in the real market without clear cut criteria on what the objectives of the pilot are. Given the vast diversity of the market eco-system, there might not be consensus from the pilot and as a result we fear a marketplace that is allowed to linger on while we search for conclusive evidence of benefit/harm either way. With that in mind, we would recommend that there are very clear cut and measurable criteria defined over a specified time period in order to evaluate proposals.

Some of the criteria items could include minimum marketshare threshold, percentage of time that the market is quoting at NBBO or better, diversity of IIROC members utilizing the new marketplace.

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?**

See answer to Q16

While much attention has been paid to Hybrid due to its non-conformity to the current set of regulatory rules, we encourage regulators to look at some of the other positive ideas put forward by Aequitas. We would reiterate and highlight the passive preferencing of non-SME trades on the Lit market as a genuinely unique and valuable feature proposed by Aequitas. It fits within current regulatory rules and tackles one of the more fundamental issues related to trading: the unnecessary intermediation of trades. This is by far one of the biggest issues with the Canadian marketplace today and is further perpetuated by market fragmentation.

We thank OSC again for the opportunity to let us comment on this important topic and hope to see positive developments in our market structure as a result of disciplined rule making.

Yours truly,

Rizwan Awan, CFA
Managing Director, Head of Program Trading, Equity Products
BMO Capital Markets
1 First Canadian Place, 3rd Floor Podium
Toronto, ON M5X 1H3
T: 416-359-5195
rizwan.awan@bmo.com

James Ehrensperger, CFA
Managing Director, Head of Facilitation Trading, Equity Products
BMO Capital Markets
1 First Canadian Place, 3rd Floor Podium
Toronto, ON M5X 1H3
T: 416-359-4351
james.ehrensperger@bmo.com