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We appreciate the opportunity to comment on the following item:

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.

Advocis, The Financial Advisors Association of Canada, appreciates 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.* (the Notice). At issue is a proposed new equities exchange to be established by Aequitas Innovations Inc. (Aequitas), which is described in a proposal (the Aequitas Proposal) it has prefiled with the Ontario Securities Commission (the OSC) to operate an exchange to trade securities of senior issuers listed on Aequitas as well as securities listed on other recognized exchanges in Canada.

PART ONE: GENERAL COMMENTS ON THE AEQUITAS EXCHANGE PROPOSAL

A. Advocis: Who we are

Advocis is the country's largest and oldest professional membership association of financial advisors and planner. Through its predecessor associations, Advocis proudly continues over a century of uninterrupted history of serving Canadian financial advisors and their clients. Our more than 11,000 members are licensed to sell life and health insurance, mutual funds and other securities, and are primarily owners and operators of their own small businesses who create thousands of jobs across Canada.

As a voluntary organization, Advocis is committed to professionalism among financial advisors. Advocis members adhere to our published *Code of Professional Conduct*, uphold standards of best practice, participate in ongoing continuing education programs, maintain professional liability insurance, and put our clients' interests first. Across Canada, our members spend countless hours

working one-on-one with individual Canadians on financial matters. Advocis advisors are committed to educating clients about financial issues that are directly relevant to them, their families and their future.

Our following comments on the Aequitas exchange proposal reflect the priorities of Advocis' members and our clients.

B. Framework of the Aequitas exchange proposal

Advocis' general understanding from both Aequitas and the OSC is that the key features of the proposed trading structure reside in its order books and market making program. More particularly, we understand that the Hybrid book is intended to be a dark market with a limited amount of additional publicly available order information, and that such information will not constitute a quote. The OSC's main concerns appear to relate to the Hybrid book and its proposed market making program.

1. Dark, Lit and Hybrid: Aequitas' three order books

Aequitas' proposed exchange will include three distinct order books, known as the "Dark", "Hybrid" and "Lit" books. Each book has different functions in order to meet different trading objectives, and for each book, Aequitas plans to facilitate trading in Aequitas-listed, TSX-listed and TSXV-listed securities. The Dark book will offer no pre-trade transparency. In it matches will occur based on four criteria: price, broker, market maker and weighted size and time of order. The inclusion of weighted size and time is meant to foster larger, more reliable resting orders and deter attempts at predatory liquidity provision strategies. The intended outcome is the creation of more equitable Dark book trading regime.

The Lit book will be similar to competing order books and use a "maker-taker" approach. Its key differences from the standard model are that (1) it will employ matching priorities to ensure that orders from natural investors (retail and institutional investors who eschew high-frequency trading) enjoy a higher priority when being filled, and (2) it will benchmark its "take" fees to the take fees in existing Canadian markets.

The Hybrid book will incorporate features of both the Dark and the Lit books. It will employ the same matching priority criteria as the Dark book, but also restrict certain participants from removing liquidity. Also like the Dark book, the Hybrid will use the "take-take" fee approach, under which both sides are charged a fee for trading.

Altogether, the three books will use Aequitas' order routing technology, which will be made available to dealers and market makers at a heavy discount relative to the ever-evolving order technology relied on by participants who engage in high-frequency trading (HFT) practices. This will result in lower overall operating costs for participants.

Lastly, in terms of its operational and execution features, any party will be able to post passive liquidity in Hybrid, but access to removing liquidity will be restricted to orders that do not bear the short-marking exempt marker (the "SME marker"). All executions on Hybrid will only occur at or within the National Best Bid or Offer (the "NBBO"), as established on other visible marketplaces (the "Away NBBO"). Aequitas will display and disseminate the aggregated volume of orders resting in the Hybrid book on a price-by-price level for each price level at or within the Away NBBO. There will be no pre-trade transparency for bids less than, or offers greater than, the Away NBBO. The priority of matching for passive liquidity is price, broker, market maker, and weighted size/time. Again, as we read Aequitas' profiling, it seems that general intent is to offer a "take-take" fee model for trading on Hybrid, complemented by low fees and additional discounts on active fees for retail trading networks.

2. Aequitas' market making program

A lamentable result of traders using HFT strategies in today's exchanges is the substantial decline in the presence of traditional market makers. Aequitas' proposal will seek to remedy this situation by limiting the presence and impact of HFT. As we understand the proposal, a DEA client (a client which is granted direct electronic access by a participant dealer) would be able to act as a market maker when sponsored by a registered investment dealer that is a member of the Aequitas exchange. A market maker will enjoy a certain degree of priority benefit in all but the Lit book, and such priority will be limited to their assigned symbols (symbols will be assigned for Aequitas-listed securities, as well as for securities listed on other Canadian exchanges). Finally, a market maker may also be provided additional compensation for meeting performance standards, including preferential trading fees.

C). Policy comments on the Aequitas exchange proposal

The advent of computerized trading price discovery has opened the door to a variety of predatory practices—most prominently, those employed by high-frequency traders. It should be noted that the Aequitas proposal does not ban outright HFT tactics, but does seek to eliminate predatory and opportunistic trading practices. The proposal therefore does not call for respite not from HFT *per se*, but only from readily identifiable executions of it which are detrimental to long-term investors. It must be stated that high frequency traders can and do execute traditionally beneficial strategies, such as market making and arbitrage. The basic technology itself is value-free and easily employable

for manipulative strategies. The Aequitas proposal recognizes that an outright HFT ban is not desirable, nor is it feasible. The proposed exchange, then, is meant to be a marketplace which functions a safe harbour for issuers and investors seeking relief from high-frequency traders; in specific, it is meant as a platform for issuers seeking committed capital and for retail and institutional investors committed to realizing long-term gains in Canadian equities.

1. Understanding predatory trade practices in Canadian equity markets: concerns over data availability, regulatory responses and unintended consequences

(a). HFT and regulatory responses

Across the economies of the West, recent concern over HFT has called into question the essential fairness of trading practices in public markets. While the notion of what it means for a financial market to be "fair" is a complex one, it is significant that every provincial and territorial regulator in Canada states that part of its mandate is to protect and promote the fairness and efficiency of the security markets under its jurisdiction, as well as investors' confidence in that fairness and efficiency. Indeed, one might conclude that the primary goal—by an overwhelming margin—facing a market regulator in Canada is to ensure the continued fairness of market access and operations, and the public perception of the same. We would suggest that our domestic securities regulators have little choice but to act immediately on the issue of HFT and the impact of similar predatory practices; with the benefit of hindsight, it might be fair to say that more steps should have been taken by regulatory authorities and concerned stakeholders prior to this point. Now, however, we have an actionable proposal from Aequitas and its backers.

In other jurisdictions, meanwhile, it appears that the regulatory response to HFT has been gaining speed. In August 2013 the Australian Securities and Investments Commission (ASIC) released new market integrity rules on dark liquidity and high-frequency trading, and related documentation meant to clarify ASIC's expectations of market operators and participants. In the coming months, further ASIC guidance on automated trading and market manipulation is expected. In the United Kingdom, the Foresight Committee of the government's Department for Business Innovation and Skills released in November 2012 its report on "The Future of Computer Trading in Financial Markets," which amounted to a survey of the received wisdom on the dangers of HFT and the standard regulatory responses, such as enhanced circuit breakers, *et cetera*. What is most notable about the committee's conclusions is that it does not want to ban HFT outright, but, like Aequitas, seeks only to curtail the negative aspects of its impact.¹ The ongoing engagement of the U.S.'s Securities and Exchange Commission with the HFT issue is well-documented. Arguably, while foreign regulators have grasped the urgency of the problem and are preparing to act, the situation in

¹ The Government Office for Science, *Foresight: The Future of Computer Trading in Financial Markets* (2012). Online at <http://www.bis.gov.uk/foresight/our-work/projects/published-projects/computer-trading>.

Ontario has now reached the stage where responsible market actors are in effect now seeking to remedy the problem on their own by way of creating a new trading venue.

(b). Data availability on HFT

Numerous Canadian market commentators in the popular business press and in trade publications have editorialized on the use of HFT for predatory purposes and the resulting harms to our equities markets. The HFT problem is part of a larger technological-driven trend in securities markets with significant implications for the typical investor. In North America the average length of holding for a security has been in decline for several decades. It is estimated that, based on the New York Stock Exchange's index data, the mean duration of the U.S. investor's holding period was roughly seven years in 1940. This period of duration remained quite stable up to 1975. But by the 1987 market crash the average holding period had fallen to under two years and by 2000 had fallen to under one year. By 2007, it was down to roughly seven months.² With the advent of HFT technology and practices, large segments of North American equities markets were being traded by HFT-driven firms with ever-shortening hold periods. As far back as 2008, the founder of Tradebot, a large U.S.-based high-frequency trader, publicly stated that his firm typically held stocks for approximately 11 seconds.³ Nowadays the comparative advantage in HFT execution has moved from microseconds to nanoseconds.

One when attempts to look beyond these basic data points, however, it becomes apparent that information related to HFT practices in Canada is unfortunately not often comprehensive, reliable, or timely. The popular business press has reported claims that anywhere from 25% to 75% of securities trades in our domestic markets are HFT-related. Moreover, the length of the average holding time for securities in Canada is not known with an acceptable degree of accuracy. We would argue that maintaining public confidence in the markets means that all stakeholders should be able to access this and similar data, and that such data should come with a higher degree of accuracy than hitherto seen. Presumably the federal government's role under the terms of the coming cooperative capital regulator will help in better overall data gathering and assessment. We find the overall lack of clear information and data on predatory pricing in Canada to be problematic. While there is much to indicate that is a significant HFT-related problem, we cannot get a full, clear grasp on the scope of the situation.

However, in May 2013, the Investment Industry Regulatory Organization of Canada (IIROC) announced it is moving ahead with the third phase of its HFT study, in order to determine the

² See the discussion in "Duration of Stock Holding Periods Continue to Fall Globally." Online <http://topforeignstocks.com/2010/09/06/duration-of-stock-holding-period-continues-to-fall-globally/>.

³ Julie Creswell, "Speedy New Traders Make Waves Far From Wall Street," the New York Times, May 16, 2010. Online http://www.nytimes.com/2010/05/17/business/17trade.html?_r=0.

impact HFT has on the integrity and quality of the Canadian equity markets.⁴ The most recent data available from IRROC reveal the staggering impact of high-frequency traders (defined by IIROC as those participants who exhibit a high order-to-trade ratio) on Canadian capital markets: they represent 22% of trading volume, 32% of dollar value, 42% of all trades and 94% of all order messages sent in Canada. In addition, they account for 60% of all Canadian trading in exchange-traded funds and notes, and 35% of all Canadian share volume traded in U.S. inter-listed securities.⁵ What's more, HFT-active participants trade a larger percentage of total dark activity than displayed market activity and trade primarily outside of the opening or market-on-close trading sessions.

(c). The impact of HFT

All in all, then, it seems almost beyond dispute that HFT is a defining feature of our equity markets. But what of its impact? For Ontario's investors and firms, the impact of HFT is both positive and negative—though attempts to reliably quantify the harm caused by HFT are few and far between, as the literature which deals with HFT in Canadian equity markets is meager. As such, generalizations must be made from studies conducted in foreign jurisdictions—a less-than-optimal situation. Nevertheless, the received wisdom on the impacts of HFT may be broken down into the following categories:

1. HFT disrupts true price discovery: HFT creates mispricing in the market by increasing volatility and inhibiting true price discovery;
2. HFT negatively impacts prices of listed companies: a major ongoing concern is that the actual price of their stock and the transaction that price was executed upon was influenced by a predatory trading practice, such as front running, or was otherwise influenced in a non-natural manner by HFT;
3. HFT increases the degree of equity market volatility: algorithmic trading increases volatility for all categories of securities;
4. HFT leads to negative outcomes from “quote stuffing”: quote-stuffing decreases liquidity and increases trading costs and short-term volatility, and the increased number of cancellations skews market –supplied information as events unfold;

⁴ Investment Industry Regulatory Organization of Canada, *IIROC Study of High Frequency Trading – Phase III – Request for Assistance* (13-0125), May 2, 2013. Online at http://www.iiroc.ca/Documents/2013/fdc69272-9280-4e14-8308-88958f959c29_en.pdf.

⁵ *Ibid.*, p. 4.

5. HFT unfairly impacts smaller traders: HFT-reliant firms earn profits by exploiting the trading patterns of ordinary traders. Traders who do not employ a “smart” order router incur higher trading costs. HFT also increases adverse selection and provides inequitable advantages for large institutions over small ones, as unfairly allocated technology costs disproportionately hurt smaller traders;
6. HFT both provides and removes liquidity: HFT both supplies and removes liquidity: when an HFT-reliant actor supplies liquidity, it experiences adverse selection in short-term price movements, but reaps profits once rebates were accounted for. Moreover, HFT-driven liquidity levels can be exaggerated, as consolidated liquidity from HFT is often overstated due to duplicate limit orders on various venues which are automatically cancelled upon execution of one of the multiple orders. Conversely, when an HFT-reliant actor takes liquidity, the perception—and non doubt in many cases, the reality—is that the trader has merely earned profits after acting on an informational advantage due to short-term price prediction; and
7. HFT and related predatory practices result in various trading- and firm-related liquidity impacts: in general, algorithmic trading, as evidenced by the amount of message traffic on an exchange, can improve overall informational efficiency and improve liquidity for large firms, but reduces liquidity for small firms. As well, increased liquidity from algorithmic trading unfortunately leads to less equity issuances and more securities repurchases.

To sum up: predatory HFT is disruptive to Ontario securities markets, and particularly to the operation of true price discovery within them. HFT negatively impacts liquidity, and disadvantages long-term retail and institutional investors. Moreover, companies invested in or listed on Ontario’s capital markets suffer when their performance and returns are negatively affected by HFT. Indeed, the price and range of financial products offered in Ontario can also be placed at risk by unchecked HFT-based predation.

(d). Regulatory responses and unintended consequences

A paramount concern of Advocis is whether regulatory action—including the granting of the Aequitas proposal—will result in HFT-reliant firms scaling back operations in Ontario’s capital markets in favour of other exchanges located in the rest of Canada, as well as abroad. Such an outcome could have significant negative impacts on current market valuations and liquidity levels. In this regard, it would have been helpful if the OSC Notice provided more in the way of information with regard to documented outcomes in those jurisdictions which have halted HFT activity. We find the overall lack of clear information and data on predatory pricing in Canada in general and Ontario in particular to be problematic.

It is important for stakeholders to have access to such data in order to fully assess the pros and cons of the Aequitas proposal. We must be mindful of potential unintended and unforeseen consequences, such as the potential impact on liquidity if significant HFT players scale back their operations in Ontario.

2. Additional policy considerations when evaluating the Aequitas proposal

Before addressing the specific questions in the OSC Notice, we wish to emphasize our belief that that the Aequitas proposal should be subjected to a review informed by several themes which are extraneous to it. To begin with, the very subject of evaluating an exchange model is daunting. The well-known scholar of securities exchanges, Rueben Lee, begins his monograph *What is an Exchange?* with the only slightly sardonic observation that:

the existence and nature of exchanges used not to be controversial. They were easily identified and characterized. New technology, however, has led to the birth of a previously unknown type of institution, the 'MONSTER' (a Market-Oriented New System for Terrifying Exchanges and Regulators), which has meant that this is no longer true.⁶

Given the complexity and richness of the exchange architecture set out in the Aequitas proposal, one feels compelled to commend the OSC for the thoroughness of its response in its Notice regarding the Aequitas pre-filing. The efficiency, safety, and soundness of Ontario's capital markets depend on the operation of the core exchange infrastructure. That there is no consensus on how exchanges should operate beyond the adherence to certain indisputable principles and norms such as efficiency and fairness is both frustrating and liberating.

Accordingly, before responding to the OSC's specific questions, we wish to emphasize here several general points we believe should be considered in any analysis of the Aequitas proposal—or for any proposed new exchange, for that matter.

As we will elucidate more fully below, the OSC has before it a solution to a regulatory problem that: (1) has the potential to be an effective solution available at a low cost to the regulator, as it is supported from responsible market participants who want to offer issuers and investors a way to avoid the harmful outcomes linked to predatory trading practices; and (2) is consistent with both National Instrument 21-101 *Marketplace Operation* and the OSC's most recent Statement of Priorities.

⁶ Ruben Lee, *What is an Exchange? The Automation, Management and Regulation of Financial Markets*. Oxford: OUP, 1998, p. 1.

(a). A market-driven solution

Some of the best and most innovative regulatory design proposals of recent times have emerged in the wake of the Global Financial Crisis. These new proposals and models typically seek to eliminate or otherwise amend three main forms of regulatory failure:

1. flawed governance policies, including those characterized by remuneration incentives which skew market activity in favour of short-term profit-taking;
2. current regulatory mechanisms which, though predicated heavily on the laudable and prudential goal of risk reduction, fail to monitor and regulate the advent of ever-more-sophisticated technological trading systems, and thereby inadvertently lead to excessive incentives and opportunities for arbitrage and other predatory behaviours; and
3. regulatory regimes which neglect to monitor for and react to systemic issues of liquidity and credit risk.

Foremost among these new models are those approaches which augment both a rules-based and a principles-based regulatory scheme with behavioural or ethical norms. These integrity-based norms must be rooted in the institutional culture and actions of the market participants themselves.⁷ In very summary terms, this type of model holds that for such integrity norms to be effective, they must already be embedded in the very development of the regulatory model itself, and indeed already present in the institutional cultures of the market participants involved in the model's development and operation. Otherwise, as recent history shows all too well, these norms will simply be transacted around, and the larger participants will simply decide to pay whatever regulatory fines which may eventually be administered against them for normative transgressions as an acceptable cost of doing business.

We believe that the Aequitas proposal is a particularly well-developed instance of this new rules-principles-norms approach: clearly, trading and issuing firms will have to commit whole-heartedly to the rules, principles and norms of fair access, true price formation, market making and liquidity maintenance set out by Aequitas before being allowed to join the scheme of the new exchange.

Further, it is interesting to review the specifics of the publicly-disclosed founding owners of Aequitas. In the main, they are mainly buy-side investors (as opposed to bank-owned broker dealers, who might be expected to champion any exchange model which lets them capture a larger-

⁷ See, for example, the discussion of leveraging institutional norms of integrity by embedding them directly into the design of regulatory frameworks and mechanisms by Justin O'Brien in "Retrieving the Meaning of Accountability in Financial Market Regulation," Speech to the Institute of International and European Affairs, November 5, 2009, Dublin, Ireland. Online <http://www.iiea.com/events/the-future-of-financial-regulation-retrieving-the-meaning-of-accountability-in-capital-markets>.

than-average portion of various trading fees and costs). Ownership is capped at 15%, and includes the mutual fund company CI Investments Inc., the financial services firm IGM Financial (sole owner of Investors Group and Mackenzie Financial Corporation, and almost all of Investment Planning Counsel Inc.), the federal pension fund PSP Public Markets Inc., the Ontario pension fund OMERS Capital Markets, communications giant BCE Inc., the technology company and execution brokerage ITG Canada, and the banking conglomerates Barclays Corp. Ltd. and the Royal Bank of Canada.

Given the range of stakeholders already backing the project, the Aequitas proposal clearly enjoys support among a relatively diverse group of companies. Should the Aequitas proposal adequately address the concerns raised in the questions contained in the OSC Notice, we would believe that the proposal has already indicated that it is a reflection of a normative commitment to a robust vision of “exchange fairness,” and that the OSC should consider green-lighting the proposal. The proposed exchange could serve as an exemplary model of how the regulator and market actors can pool their expertise to initiate a reform which is in the best interests of consumers, especially those saving for retirement or who are already retired and therefore dependent on stable share performance.

(b). Consistency with National Policy 21-101 and the OSC’s Statement of Priorities

As will be seen below, the Aequitas proposal fulfills the “reasonableness test” governing fair access which is set out in National Instrument 21-101 *Marketplace Operation*. As well, the proposal clearly falls within the terms of the managed evolution of market structures, the OSC’s own *Statement of Priorities for 2013-14*, which states that:

The OSC will continue its work on initiatives that aim to foster fair and efficient markets and trading. Markets have experienced significant change and innovation in their structures over the past five years, largely due to advancements in technology and increased competition. It is an enduring objective of the OSC’s work in this area that markets remain fair and participants have confidence in market quality and integrity, including order-entry, execution and settlement processes.⁸

Again, should the Aequitas proposal adequately address the concerns raised in the OSC Notice, we believe that the OSC can and should take a large step towards fulfilling this priority by granting approval to the Aequitas submission.

PART TWO: RESPONSES TO THE OSC’S SPECIFIC QUESTIONS

For your ease of reference and review, Advocis’ has reproduced the OSC Notice’s question-and-answer scheme below and inserted its comments and concerns in the appropriate locations.

⁸ Ontario Securities Commission, *Statement of Priorities for Fiscal 2013-2014*. Online at http://www.osc.gov.on.ca/en/Publications_statement-priorities_index.htm.

A. Segmentation of order flow

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?

Advocis would submit that OPR rules should apply to all visible markets. In circumstances such as the Hybrid proposal, where trade pricing is determined by reference to NBBO and where the order book does contribute to the establishment of NBBO pricing, it is not necessary to apply OPR to the orders.

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 orders on Hybrid. The reasons for this are numerous and technical, but three specific ones stand out for us: (1) we believe that any posting of large passive retail orders will be limited in frequency and driven by best execution considerations; (2) the Hybrid market will segment according to the ability to remove liquidity as based on IROC's approach to the SME market, so non-SME orders will be based in the lit aspect of the Hybrid market by way of participation in the NBBO. This means that in the result that the OPR rule will apply to non-SME orders on Hybrid, as on any other lit market, so that in practice the Hybrid market will behave as a lit market for non-SMEs; and (3) Aequitas' proposal appears to us that it will provide non-SME investors with access to the potential for a better quality of fill, and it will otherwise behave as a dark market, with the characteristic features of restrictions on types of orders and a reference-based pricing regime.

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?

Since Hybrid will not be subject to the OPR, its quotes should not be incorporated into the consolidated display. Including best-priced displayed orders in the consolidated display requirements would simply amount to a circularity of referencing, with no beneficial impact on the system of price discovery.

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?

Since the Hybrid is not a protected quote, it doesn't seem to us an appropriate tool for establishing a reference price. The NBBO therefore should not include the Hybrid's best bids and best offers; thus, constituted with those restrictions, the NBBO will be the appropriate reference price—as often seems to be the case for dark pools in general.

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?

It is important to note two issues here: (1) *National Instrument 21-101 Marketplace Operation* applies to *all* marketplaces, including the Aequitas proposal, and (2) the test on access requirements, set down in section 5.1(1), clearly states that the standard is a negative one: “A marketplace must not unreasonably prohibit condition or limit access by a person or company to services offered by it.”⁹ The “not unreasonable” standard is not the same as a “reasonableness” standard, and for a sound policy reason: the applicant must not prove the higher standard of reasonableness, but the lower standard of “not unreasonable”—that is, Aequitas doesn't have to prove that its proposal will succeed on all fronts or with all parties with regard to the provision of access, merely that its prohibitions on access are not unreasonable, which is to say, are not arbitrary, or high-handed or capricious. The wording of the fair access requirements clearly contemplates the possibility that some forms of restriction on access can be judged as reasonable.

It seems inarguable to us that a proposal which restricts access not on the basis on organizational identity but on the purely functional basis of the use of deleterious, technology-driven trading strategies, and does so in the interests of non-SMEs, is clearly “not unreasonable” and therefore permissible under *National Instrument 21-101*.

We would further argue that for the fair access principle to have real meaning for investors, the OSC must accept the reality that fair access is already being limited for many long-term investors through the use of predatory HFT strategies. It is entirely reasonable—and entirely within the OSC's mandate—to permit the operation of an exchange which seeks to allow traditional investors a means of avoiding the harmful outcomes they experience in lit markets due to their being placed at unavoidable disadvantages in terms of cost and execution quality.

⁹ Canadian Securities Administrators, *National Instrument 21-101 Marketplace Operation*. Online at http://www.osc.gov.on.ca/documents/en/Securities-Category2/ni_20120701_21-101_unofficial-consolidated.pdf.

Moreover, under the Aequitas proposal, both member participants and non-member participants will be subjected to the same access restrictions. The Aequitas restriction on active SME active flow is reasonable simply on the basis that these restrictions are done in the name of improved market quality, and in order to address harm in the marketplace. As long as the Aequitas exchange can operate so that the segmentation of order flow is restrictive of unfair behaviour but supports positive trading activities, we would submit that the proposal must be approved under the terms of *National Instrument 21-101* and the OSC's own mandate.

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 markets, while offering transparency, are also subject to predatory trading practices which undermine the values of fairness and integrity, especially for long-term investors. Dealers in visible markets are also subject to increased data costs, which are then borne in part by the retail investors. The Hybrid market promises to restrict such predation, to allow a more natural trade flow without the effects of HFT, and therefore to boost investor confidence in the legitimacy of market outcomes. We do not deny that speculation and arbitrage can be key element in the price discovery process in visible markets, but we also believe that market actors should be offered a choice in venue to escape their very real perceptions of harm to both issuers and investors from rampant HFT.

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

Based on the foregoing, and assuming it has a "natural" and not a "predatory" order flow, we would assert that the Hybrid market is without question consistent with the application of the applicable fair access requirements.

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

The IIROC definition of the SME marker resembles standard descriptions of predatory trading practices and behaviours. As such, it is clear that the SME marker is the most appropriate tool available for identifying the behaviours Aequitas seeks to restrict. One can easily imagine that HFT firms could evolve their trading approaches in order to appear to be non-SME-compliant. Perhaps the use of another metric, like high order-to-trade ratios, would filter out such efforts. Conversely, when SME market order flow is on its face not in fact predatory, it should be permitted by Aequitas. Such refinements to the delineation of the SME marker would have to come over time. For the

present, we would suggest that clear guidance on the use of the SME market be provided by IIROC and/or the OSC, to ensure market actors are all operating with the same understanding of the SME market.

B. Aequitas' market making program

Aequitas acknowledges that certain parts of its market making program are critical to its model's success. As will be seen below, we believe that these key components are designed in a way acceptable to the OSC.

1. Market maker priority

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

Robust market making is a key to an effective and efficient market—and to the proposal at issue at hand. To an extent, Aequitas recognizes the need to properly compensate market makers with matching priority for the risks they assume in maintaining liquidity and providing sufficient levels of price formation, discovery and stability. The matching priority offered by the Dark and Hybrid markets is not, as we understand it, likely to have any negative effects on impact on market quality or liquidity.

In addition, whereas the standard exchange's maker-taker fee regime clearly puts the retail investor at a disadvantage, since he or she is very often a liquidity taker, Aequitas' fee model for market making in the Hybrid and Dark markets will provide a welcome contrast for the retail investor. We are confident that Aequitas will put in place a low enough fee structure will attract retail order flow. In fact, to do otherwise would be self-defeating for the proposal.

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?

As we suggest above, there is an attractive sense of proportionality and fairness to the proposition that any market maker who receives priority in the Dark and Hybrid books should also have with matching obligations in the Dark and Hybrid books.

Of course, the position Aequitas takes is that the rights and obligations of a market maker need not reside in the same book, as long as the overall operation of the entire exchange is effective and

efficient, and we concede that that overall effectiveness and efficiency is what is of ultimate value and significance. As such, we are prepared to support the Aequitas proposal as it now stands.

It is, in the final analysis, a question of how many market makers would be willing to assume obligations for all three books. Certainly, as a *de minimus* standard, the market maker must be obliged by Aequitas to maintain liquidity for the Lit book: investors must be assured that the market maker is positioned to fulfill its most important safeguarding function by acting as the final provider of liquidity.

We would submit that market makers' obligations, and the means of monitoring of them, should be explicitly specified in the event the Aequitas proposal is approved by the OSC.

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?

Attempting to restrict market making to the market in which the security is listed will strike some stakeholders as fair and others as an arbitrary line-drawing. We would suggest that letting market making benefits accrue with respect to all listed securities will result in the entrenchment of a robust ongoing incentive for the market maker to monitor and maintain ongoing levels of appropriate liquidity. This beneficial incentive should prove sufficient to ensure appropriate behaviour from the market maker.

We would also note that, with regard to fairness, letting market making benefits accrue to market makers across all securities is merely consistent with the long-held practice of permitting trading in exchange-listed securities in multiple markets.

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?

The introduction of additional market making capacities is a goal worthy of regulatory support—and oversight. Such oversight may be exercised by requiring that DEA client market makers be appropriately qualified.

We would suggest that “appropriately qualified” entails the DEA client being a member of a self-regulatory organization such as FINRA, sponsored by an IIROC member, and subject to that member’s oversight, and perhaps by the OSC as well by way of random periodic review. Such review would have to be funded through the operation of the Aequitas exchange. This seems a workable practice to us and is one with some degree of precedence, since sponsoring IIROC members will pass through the credits earned by DEA clients who execute passive trade orders.

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 of fairness or market integrity?

We would expect the Aequitas proposal to produce a level playing field, as long as both types of market makers are subjected to the same degree of oversight and control, and are required to adhere to the same standards and principles. Sponsoring brokers should be able to subject the DEA client market makers to those standards; indeed, doing so would be consistent with the actual practices and outcomes seen in sponsored access trading in general.

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?

Such prognostication is always dangerous, but based on the details of the proposal, one would expect that the Hybrid will lead, over the medium- to long-term, to an improvement in the quality and integrity of the visible market, improve the liquidity of exchange-traded securities and generally benefit long-term investors.

Competition in exchanges—like competition for market maker positions— has proven to lead to enhanced outcomes for issuers and investors. This means that it may be possible that even in the very short-term, the Hybrid could realize its anticipated outcome and let investors access the market at a lower cost and enjoy more efficient price discovery, so that they are soon trading at prices they are confident are not subjected to distorting influences such as HFT.

If this happens, then the next outcome should be a reduction in short-term and even same-day volatility and, as we suggested above, an increase in the amount of natural liquidity throughout the market, as firms which are presently subject to active predatory strategies are progressively freed from the impact such strategies.

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 believe that the potential benefits of Hybrid outweigh its potential risks. It will create new opportunities for retail and institutional investors and remove the technological edge currently enjoyed by those market participants who employ HFT strategies and drive up costs for all participants (not to mention the costs of engaging in the race to develop the next quarter's most effective HFT algorithm).

We would argue that these costs, and the resulting loss of both natural liquidity and investor confidence, more than offset any minute economic value generated by predatory strategies. Such value is not distributed back to those who bear the negative impact of HFT.

Broadly put, we believe that there is every chance that, enhanced levels of investor confidence, improved levels of natural liquidity, lower data costs and more efficient price discovery and display mechanisms will result from the Aequitas proposal.

In terms of risks, the first main risk is short-term, and would entail ingenious HFT-employing market participants, as we alluded to above, finding a way to "game" the SME maker by appearing to be within the boundaries of the non-SME marker. The second main risk is likely to appear only over the medium-term, and it is a risk not to investors but to other exchanges. Aequitas' is seeking to attaining 20% of all Canadian stock trading in less than five years. While ambitious, this target may in fact be achievable. It will be recalled the Alpha Exchange had attained about 30% of the trading activity in Canadian-listed securities when its bank backers bought the TMX in 2012.¹⁰ In the event that if the Aequitas proposal fulfills its expectations, the Aequitas exchange will likely absorb trading from other lit markets, particularly if the order flow and price discovery on them becomes saturated with HFT-generated effects.

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 re-evaluated based upon some criteria or threshold? What type of criteria or threshold might be appropriate to minimize potential negative impact?

¹⁰ Jim Middlemiss, "Old rival, new high ground," *Listed Magazine*. September 16, 2013. Online at <http://listedmag.com/2013/09/old-rival-new-high-ground/>.

While any new undertaking becomes more attractive when it is proposed as a pilot program, and subject to a rigid timeframe, so it may be wound-up if it proves unpromising. However, we would argue that placing the Aequitas proposal in a pilot track would be entirely counterproductive, given that is intended in large part to defeat HFT strategies and bolster investor confidence.

One when considers the level of ingenuity and patience shown by market actors who rely on HFT, one would expect that they would simply wait out the pilot period, and if the exchange is granted permanent status, then—and only then—attempt to circumvent the SME marker system. In other words, granting the Aequitas proposal pilot status will signal the very participants whose impact on it would need to be measured to determine the proposal's success to simply avoid the exchange altogether until it is made permanent. No useful information in regard to predatory strategies would be gathered during the pilot period. Outright approval from the regulator would avoid this perverse outcome, but adjustable safeguards could be put in place to mitigate macro-levels of risk in the early stages of the exchange's operation, in the form of thresholds based on the exchange's market share, trade size, etc. (On the micro-level, similar thresholds could be put in place on individual securities' trading volumes, etc., though this might be result in the exchange in effect running counter to the very policy goals proffered for it by Aequitas in the first place).

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?

No, Hybrid should not be required to be modified to fall within established regulatory parameters for either visible or dark liquidity. To do so would undercut the entire rationale for the program. If the Aequitas proposal is worth doing on the basis of it expected beneficial outcomes, then it must be done largely according to the terms set out by Aequitas, which we believe to be balanced, reasonable, and fair.

Indeed, it must be done largely on those terms because modifying the Aequitas structure so it can be subsumed under the existing regulatory framework will, at best, simply result in a replication of the *status quo*—of the very condition from which the proposal seeks to differentiate itself. An Aequitas exchange which departs from the SME-marker regime set out in the proposal might end up producing outcomes not very different from those produced by Ontario's currently accepted exchange models; in the end, it would simply be competing with better-established versions of itself. Nothing of innovative value would be gained from such modification for issuers or investors.

Accordingly, we believe that the OSC should grant any exemptive relief Aequitas needs to bring its proposed market to market, as it were. The remainder of our comment letter sets out several further points we wish to offer regarding the proposed exchange model.

CONCLUSIONS AND LOOKING AHEAD

By way of conclusion, upon careful review of the Aequitas pre-filing, we believe that proper implementation and operation of the proposed exchange model should lead to a set of beneficial outcomes.

1. Positive exchange-based outcomes

We believe that the Aequitas exchange, in a relatively short period of operating time, could produce both positive quantitative and qualitative outcomes, including improved levels of liquidity and an enhanced sense of investor fairness and market confidence. The proposed elements of the Hybrid book could result in appropriate levels of natural liquidity being preserved for long-term investors. Indeed, the order mechanism which is intended to ensure that large patient resting orders are filled first on a priority basis is in itself very nearly a justification for the entire proposal. The expected operation of the Lit book promises to ensure that “real” investors are able to enjoy a priority over those relying on predatory tactics. In terms of the benefit for listed companies, instead of high frequency traders realizing gains, we expect that it will be small- and mid-cap issuers who will receive the benefits of trading under the Aequitas system. Finally, in terms of the role of market makers, the OSC’s concern about possible conflicts may be addressed by the fact that all participating firms will be fully aware of the presence of market makers—and they will be watching for the requisite degrees of liquidity money makers are expected to provide on the new exchange.

2. Positive meta-exchange-related outcomes

The proposed model has the definite potential to lead to much-needed exchange competition in Ontario and indeed in Canada. If properly executed, it will also help position Ontario—and our fledgling co-operative capital regulator—as innovators on the global stage.

3. Positive management of HFT-related outcomes and fulfillment of various fairness criteria

In terms of the ethical underpinnings of the Aequitas proposal, we wish to offer a few final words on fairness and HFT practices. While the notion of what it means for a financial market to be “fair” is a complex one, it is significant that every provincial and territorial regulator in Canada states that part of its mandate is to protect and promote the fairness and efficiency of the security markets under its jurisdiction, as well as investors’ confidence in that fairness and efficiency. To fulfill these terms in the OSC’s mandate, the Aequitas proposal seeks to offer a safe harbour not from HFT *per se*, but only from readily identifiable predatory executions of HFT. It must be stated that high frequency traders can and do execute traditionally beneficial strategies, such as market making and arbitrage; after all, the technology itself is value-free and while easily employable for manipulative strategies,

it need not be used in that manner. The Aequitas proposal correctly recognizes that an outright HFT ban is not desirable, nor is it feasible.

It is our belief that procedural fairness dictates that the Aequitas proposal be viewed through the principle of equality of access and opportunity. According to this principle, market participants, despite their differences, should be essentially treated alike. Under the Aequitas proposal, the same rules apply to HFT as to other traders. Aequitas appears on our understanding of its profiling to fulfill this procedural criterion. Substantive fairness, or more particularly fairness in outcomes, or in access to those outcomes, is more complex and is conceptually problematic in the market context of winners and losers. In this regard, one should simply note that HFT strategies can be beneficial to other market participants, including retail investors, so one must conclude that HFT practice is not an *a priori* unfair practice. Once that conclusion is reached, it becomes a question of whether the proposal will weed out as best it can only those HFT practices which lead to negative outcomes and otherwise operates on a fair and impartial basis. Again, we believe that this is what the Aequitas submission proposes to do with regard HFT firms. And in terms of the fairness of its operational structure, Aequitas' proposal will dispense with the standard "maker-taker" fee model, which supplies rebates to firms which provide liquidity and charges fees to firms which remove liquidity; instead, the proposal will employ a "take-take" model in two of its three order books, so that both sides of the fee transaction will pay a comparatively low fee. The result will be lower operational costs for all parties accessing the exchange. We believe, therefore, the Aequitas proposal to be a manifestly fair one in terms of access and operation.

4. Advocis is pleased to support the Aequitas proposal

For all of these reasons, we would urge the OSC to allow Aequitas to move ahead with its proposal. However, we do so with the proviso that while we support the spirit and design of the Aequitas proposal, we are also mindful of the possibility of unintended and unforeseen consequences—such as the potential impact on liquidity in our capital markets if significant HFT players scale back their operations in Ontario.

As well, we find the overall lack of clear information and data on predatory pricing in Canada to be problematic in permitting us to provide a full and complete response to the OSC's Notice. Nevertheless, despite our express reservations on the issues of data availability and interpretation, we believe that predatory HFT is disruptive to Ontario securities markets (particularly to the operation of true price discovery within them), results in detrimental liquidity outcomes, and disadvantages smaller traders and long-term retail and institutional investors. Moreover, companies invested in or listed on Ontario's capital markets no doubt suffer when their performance and returns are negatively affected by HFT. Indeed, the price and range of financial products offered in Ontario is very likely placed at risk by unchecked HFT-based predation.

At Advocis, we represent advisors and their clients, and we are committed to regulatory reform and innovation which advances their common interests. Based on our understanding of both the beneficial and detrimental impacts of HFT in Ontario’s capital markets, and on our comprehension of both the stated goals and the technical features of the Aequitas exchange model, and subject to the certain noted qualifications we have made throughout this document, we are pleased to offer our support to the Aequitas exchange proposal.

We appreciate the opportunity to provide comments on what we believe to be an exceptionally innovative Aequitas proposal, and we would be pleased to offer further comment or assistance on this matter at any time. To do so, please contact Ed Skwarek at eskwarek@advocis.ca.

Sincerely,



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