FAIR | Canadian Foundation *for* Advancement *of* Investor Rights

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Market Regulation Branch
Ontario Securities Commission
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Re: Proposed Trading Structure for Aequitas Innovations Exchange

FAIR Canada is pleased to offer comments on the proposed trading structure for an Exchange that Aequitas Innovations Inc. proposes to establish (the “Proposal”), in response to the Ontario Securities Commission (“OSC”) staff notice dated August 8, 2013 (the “Notice”).

FAIR Canada is a national, non-profit organization dedicated to putting investors first. As a voice of Canadian investors, FAIR Canada is committed to advocating for stronger investor protections in securities regulation.

FAIR Canada notes that the concepts and issues covered by the Notice are too complex for investors to grasp and respond to, except sophisticated institutional investors. FAIR Canada submits that the complexity of the issues should not lead to a policy debate that is dominated by the views of marketplaces, large securities dealers (a number of which have ownership stakes in marketplaces) and high frequency traders (HFTs). The views and concerns of investors should be of significant interest to regulators. Partly for those reasons, FAIR Canada considers it important that we respond to the request for comments. In addition, the Proposal is intended to respond to a number of market structure and fairness issues that FAIR Canada has expressed concerns about.

FAIR Canada Comments – Executive Summary

1. FAIR Canada supports the benefits the Proposal is purported to achieve based on concerns about manipulative and deceptive trading practices of HFTs and the impact of current market structure, pricing model and services on investors. Market-based solutions to current market structure and market integrity issues are welcome and innovation that may address existing problems should be encouraged. It is important not to rely only on regulatory controls and intervention to address market integrity and fairness issues.

2. Innovative solutions must satisfy core principles of market regulation that aim to protect investors, ensure fairness in trading markets and promote market integrity. However, it may be appropriate to permit reasonable exceptions to the current rules for lit and dark markets in order to enable new market models to be tested.

3. FAIR Canada believes that only allowing retail and institutional investors to take liquidity in the hybrid book is a reasonable limitation on the fair access principle.

4. FAIR Canada does not object to new approaches to market making being tested, but the rules must ensure that market makers' obligations provide meaningful benefits to investors and market quality.

5. FAIR Canada does not object to an exchange having market makers for securities listed on other exchanges because it should promote competition among marketplaces.

6. FAIR Canada believes that all market makers must be subject to uniform regulation, including registration, clear rules, standards and effective monitoring of trading.

Detailed Comments

1. FAIR Canada supports the benefits the Proposal is designed to achieve but does not at this time express an opinion as to whether the Proposal achieves those benefits. Market-based solutions to current market structure and market integrity issues are welcome and innovation should be encouraged. Innovative solutions must satisfy core principles of market regulation that aim to protect investors, ensure fairness in trading markets and promote market integrity. Details of the Proposal must be provided before stakeholders can take a position on the launch of the proposed Exchange.

1.1. FAIR Canada has expressed a number of concerns about manipulative and deceptive trading practices used by HFT (see submission of October 15, 2012 to IIROC on Proposed Guidance on Certain Manipulative and Deceptive Trading Practices) and issues in the market structure for equities trading. Concerns include fairness and transparency of markets, undue volatility caused by HFT and other short-term trading based on automated trading strategies, and the impact of short-term trading strategies on raising capital.

1.2. FAIR Canada supports the principle of a "level playing field" in securities markets and advocates that the regulators implement measures to ensure that all investors have equal access to timely market information, trading opportunities and liquidity. In this regard, we do not consider HFTs to be "investors".

1.3. We are concerned that sophisticated participants that generate very large volumes of orders and trades using HFT and other automated trading strategies are unfairly favoured by exchanges and other marketplaces over individual investors and other participants who do not generate significant levels of activity (and therefore significant profits and market share) for either marketplaces or intermediaries. Existing markets essentially permit HFTs to "front run" investor orders and reward HFTs through arrangements like co-location and maker-taker fee models. Therefore FAIR Canada welcomes efforts to respond to those issues and cater to the needs of investors. We encourage regulators to experiment with techniques to combat this unfairness including time delay (e.g. 1 second) for orders and fees for orders (including any change or cancellation).

1.4. In comments to the OSC last year, FAIR Canada also expressed concerns about the impact of the Maple Group transaction on the competitive landscape for market services. Although competition exists it has not provided significant alternatives to the market model and pricing of TMX Group Exchanges. The Proposal would likely introduce new competition in both trading and listing services, based on both pricing and the nature of services offered. FAIR Canada believes this new competition is needed in the Canadian marketplace and will be welcomed by many market participants.

1.5. FAIR Canada shares several specific concerns of market participants that are cited in the Notice, including:

- Maker-taker pricing and fragmentation of orders have led to increased (and often unnecessary) levels of intermediation.
- Technology and speed advantages of HFT firms, together with competition amongst them for passive rebates, have created an unlevel playing field and contributed to the "crowding out at the quote" of traditional investors (retail and institutional).
- The above contribute to increased trading fees for dealers, and in particular retail dealers, as it leads to these dealers being takers of liquidity (i.e., being active) more frequently and paying the taker fees, and has also led to higher trading costs for clients whose trades are crossing the spread more often to get executed.
- There is a lack of meaningful competition amongst marketplaces to address cost issues of its participants.
- Increased intermediation and the advent of HFT in high volumes has led to increased technology costs as market participants and regulators (including IIROC) attempt to deal with higher message rates and activity levels. These costs are ultimately borne by all users of the markets although the investments mainly benefit HFTs and other active, short-term traders.

1.6. Based on our concerns about the impact of current market structure, pricing model and services on investors, FAIR Canada is supportive of solutions including both regulatory and potential market solutions that will address these issues. The Proposal professes to be designed to address concerns of retail investors, institutional investors and issuers that, according to Aequitas, have not been adequately addressed by TMX Group Exchanges or other marketplaces. The Proposal promises to provide an opportunity to experiment with market-based solutions that might prove to be beneficial to investors.

1.7. We support regulatory responses to address the concerns listed above along with market innovation which furthers regulatory objectives including market integrity and fairness. It is important that all potential solutions are considered in order to address market integrity and fairness issues. Regulatory controls may have limitations and desirable or undesirable side effects (which may be foreseen or unforeseen). They also suffer from the delays and compromises inherent in the regulatory process. Innovative solutions can complement regulatory controls and could potentially reduce the need for additional regulation.

1.8. **At the same time, FAIR Canada shares OSC staff's view that innovative solutions must satisfy core principles of market regulation that aim to protect investors, ensure fairness in trading markets and promote market integrity.** Innovation must serve the interests of issuers and investors and should not be accepted without due consultation and consideration by the authorities, even on a trial basis. In particular, new approaches that would or could open the door to watering down standards and regulatory protection must be examined carefully. In this regard FAIR Canada has a number of comments on the Proposal that are set out below.

1.9. Before an opinion by FAIR Canada can be expressed on the Proposal, stakeholders must have the opportunity to review and comment on the specific details of the proposed structure, rules and services of the Aequitas Exchange.

2. It may be necessary to permit reasonable exceptions to the current rules for lit and dark markets in order to enable new market models to be tested. However, the core principles of market integrity and a level playing field among competing markets must be maintained.

2.1 If new markets must conform to either the existing lit or dark market models and rules then it becomes difficult to provide innovative solutions. There are already several lit and dark markets in Canada that are competing using the same market models. In order to test innovative solutions based on a different approach, it may be necessary to permit reasonable exceptions to technical trading regulations, as long as the core principles of market integrity are maintained and unfair competition does not result.

2.2 The proposed hybrid book in the Proposal purports to give retail investors a new option for trading their orders that combines price visibility with protection from interference by short term, automated trading strategies that have become a major factor in markets. Currently dark markets are not a realistic option for retail orders because prices and available volume are not visible. The proposed hybrid market might address those issues. Investors may also benefit from Aequitas' lit market, especially if it offers more attractive pricing than the pricing on current "maker taker" models.

2.3 Limiting the visibility of posted limit orders in the hybrid book when they are outside the national best bid and offer ("NBBO") may encourage more orders and volume to be posted, which would increase availability liquidity and market depth.

2.4 However, if the hybrid book is to respect the spirit of existing regulations, as Aequitas states, then orders in the book that are in effect either dark or visible orders should be treated as such. A dark order in the hybrid book should not be exempt from rules that apply to a dark order in a dark order book just because the nature or mechanics of the hybrid book are different. That means that a dark order in the hybrid book should be required to provide price improvement to active orders in the same circumstances as in a dark market. The character of those orders should be maintained until (and if) they become visible. Otherwise, a dark order in the hybrid book could obtain advantages not available to dark orders on other markets. This would also give the Aequitas hybrid book a competitive advantage over other markets based on regulatory treatment.

3. FAIR Canada believes that only allowing long-term investors to take liquidity in the hybrid book is a reasonable limitation on the fair access principle.

3.1 The Proposal proposes to serve the interests of investors (retail and intuitional) by prohibiting traders pursuing short term automated trading strategies from filling active orders in the hybrid book. As FAIR Canada has stated before, those strategies have led to questions about the fairness of markets for investors – especially retail investors. In our view this limitation on access should not prevent the Proposal from being approved. **It is reasonable to limit access to investors interested in the investment merits of securities, especially if the objective is to protect those persons from predatory trading practices of computerized trading systems and to improve fairness in the market.**

3.2 In order to test a system that provides preferred access to liquidity for real investors at the current market price (NBBO), the system must both limit access for traders using automated trading and provide visible pricing that matches the NBBO. Since the hybrid market proposes to use lit markets to provide the reference price, it does not preclude these traders from accessing marketplaces that are primary sources of price discovery and liquidity. However, regulators should make clear that they will not permit lit markets, the primary sources of price discovery, to limit access to, for example, institutional orders. If this was permitted it would probably lead to a 2-tier market – one for institutional or large trades and one for retail or small trades.

3.3 As the Notice states, dark markets have already been permitted to make reasonable limits on access, such as limiting access to institutional orders. **Limiting access to the hybrid market to investors' orders in order to ensure fair treatment should also be considered**

a reasonable limit. If a trading service aimed at serving investors (as opposed to automated trading systems) is to be launched, it needs to provide visible pricing information to users, so the fact that the hybrid book will be partly lit should not prevent the proposed limitation on access.

3.4 **The Notice notes that fair access raises investor confidence issues. But real investors have had to bear liquidity, execution and infrastructure costs and risks that result from the large amount of high frequency trading in markets – especially since the TMX Group Exchanges and other marketplaces have tried to cater to HFTs' needs in order to increase order flow and revenues to their markets. Those costs and risks remain concerns in spite of several regulatory initiatives designed to mitigate them. In FAIR Canada's view the problems created by HFT and the alliance of exchanges and ATSs with HFTs raise bigger investor confidence issues than the fair access issue does.**

3.5 The Proposal attempts to respond to the costs and risks faced by real investors in today's markets by offering an order book that will reduce the amount of "trading noise" and the associated costs to investors. FAIR Canada supports this, at least on a trial basis, limiting access for types of orders that have clearly caused a reduction in fairness, increased volatility and higher costs.

4. FAIR Canada does not object to new approaches to market making being tested, but it must be clear that the Proposal will ensure that market makers' obligations provide meaningful benefits to investors and market quality.

4.1 **We remain to be convinced that market makers will provide real value to investors, issuers and markets.** Market making only has value to investors if market makers are obligated to provide liquidity at prices and in market situations where liquidity would otherwise be lacking or inadequate. There is little or no value to investors if market makers only add a minor amount of size or depth to markets in stocks that are already liquid and have reasonable size or depth. That analysis should include liquidity available in other marketplaces and order books, which market makers can easily access to support their market maker trading.

4.2 **A market making model raises fairness concerns if the system does not ensure any benefits offered to market makers, such as preferential participation in trading, are earned through the performance of obligations to the market.** Market making services are not free. They have costs to other users. The market making system's rules and requirements must be clear, transparent and actively policed to ensure that market makers provide needed liquidity to investors on a regular basis.

4.3 If market makers have clear and meaningful obligations to provide liquidity, meet those obligations, and compliance with those obligations is actively monitored and enforced, then it may be justifiable to provide incentives to market makers because market makers cannot be expected to make trades that no one else will make as a public service. The challenge is to ensure that there is a fair balance between obligations and compensation. It is a particularly difficult challenge to meet because the trading characteristics of individual stocks vary so widely, and change continuously.

4.4 FAIR Canada suggests that market makers should be obligated to support prices in the hybrid book, in addition to the lit book, if necessary to provide liquidity at the NBBO. This would ensure a useful service to real investors' orders entered in the hybrid book, and increase the odds that the hybrid book will be a successful service. (The market maker orders in the hybrid book could be tied to their orders in the lit book in order to limit exposure to fills at a given price.)

4.5 **We suggest that market makers' right to priority over client orders should be capped at a specific size in order to prevent market makers from entering large orders and taking all fills available at a price until their order is filled.** After an initial allocation, market makers should be on parity with other orders. This would be perceived as a fairer system and reduce concerns about the impact on investor confidence.

4.6 In order to express an opinion on the proposed market making system, Aequitas must provide full details on how the system will work, including the specific obligations of market makers, details of proposed compensation, and details of how market makers' trading and performance will be monitored and policed by Aequitas, IIROC and any other regulators. Those details should be published for comment and considered by regulators before any market making system is implemented.

5. If regulators approve the market making proposal, FAIR Canada does not object to an exchange having market makers for securities listed on other exchanges because it should promote competition among marketplaces.

5.1 The objective of a market making system is to improve liquidity and market quality for investors and other traders. US exchanges have long had specialists or market makers for securities they post for trading on an unlisted basis, as well as for options that are posted on the initiative of exchanges. Listing and market making are separate services. The provision of market making services supports competition among markets in providing trading services, which should be promoted by regulators. Competition could be limited if only a listing exchange has the right to provide market making services.

6. FAIR Canada believes that all market makers must be subject to uniform regulation, including registration, clear rules, standards and effective monitoring of trading.

6.1 FAIR Canada agrees with OSC staff's view that market makers should be registered, regulated and monitored by IIROC for compliance with IIROC rules (particularly UMIR), and supervised and monitored for compliance with their market making obligations and exchange rules. Market makers have direct and preferential access to trading, and often significantly influence the quoted bid – ask market for their assigned securities, as well as the prices of securities. In the past, widespread abuses of market making privileges have been identified at a number of exchanges in the US, including the NYSE, Nasdaq and the American Stock Exchange, which demonstrates the need for effective oversight. Regulators will be aware of the price fixing conspiracy among Nasdaq market markers leading (among other things) to a US $1 billion settlement. Effective monitoring of market makers' trading (including by regulators) is essential. If effective monitoring is not feasible or too costly then market making should not be introduced.

6.2 In addition, as noted above, it is imperative that market makers' compliance with their obligations and overall performance be closely monitored and reviewed in light of their important role and the benefits they are entitled to. It is our understanding that historically the predecessors of the TMX have had difficulty monitoring "registered traders" to ensure that they truly provided benefits to the market.

6.3 We agree that membership in, or regulation by, a foreign body is not an adequate substitute for IIROC regulation because a foreign regulator or market will have different rules than IIROC or the Aequitas Exchange, and might lack the knowledge, surveillance tools and incentives to effectively supervise market makers' trading. Other regulators would probably have no experience with the proposed form of market making, and would lack specific monitoring tools to supervise market makers' trading and performance.

7. Is there a possible impact on the quality of price formation and price discovery for the Canadian marketplace as a whole if Aequitas attracts too much volume?

7.1 FAIR Canada is not clear on why the OSC staff is concerned about Aequitas attracting volume from other markets given that regulatory policy favours competition, which has already fragmented the markets. Therefore we assume that the concern relates to the proposed hybrid market rather than the lit market. The Proposal would introduce a different form of competition by providing an order book that uses lit markets to establish the reference NBBO prices at which real investors' orders can be filled with limited interference. Even if regulatory policy favours visible markets, that should not preclude other trading mechanisms from being tested, particularly if the objective is to mitigate the impact of trading in visible markets that has increased volatility and reduced market depth. Orders in the hybrid market at or within the NBBO must be still be displayed and will contribute to price discovery.

7.2 The Notice states that lower transaction prices might lead to more retail client orders being entered. In addition, the hybrid book aims to provide better treatment of investors' orders by limiting interference from short-term professional traders. Competition that lowers costs and improves service (efficient execution of orders) (if these purported benefits are real) should be encouraged.

We thank you for the opportunity to provide our comments and views in this submission. We would be pleased to discuss this letter with you at your convenience. Feel free to contact Ermanno Pascutto at 416-214-3443 or by email at ermanno.pascutto@faircanada.ca.

Sincerely,

Canadian Foundation for Advancement of Investor Rights