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October 3rd, 2013

Market Regulation Branch
Ontario Securities Commission
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Toronto, ON M5H 3S8
marketregulation@osc.gov.on.ca

Dear Mesdames/Sirs:

Re: OSC Staff Notice and Request for Comment re: Proposed Structure of Trading Facilities for a New Exchange Proposed to be Established by Aequitas Innovations Inc. (“Aequitas”)

The Canadian Security Traders Association, Inc. (CSTA), is a professional trade organization that works to improve the ethics, business standards and working environment for members who are engaged in the buying, selling and trading of securities (mainly equities). The CSTA represents over 850 traders nationwide, and is led by Governors from each of three distinct regions (Toronto, Montreal and Vancouver). The organization was founded in 2000 to serve as a national voice for our affiliate organizations. The CSTA is also affiliated with the Security Traders Association (STA) in the United States of America, which has approximately 4,200 members globally, making it the largest organization of its kind in the world.

This letter was prepared by the CSTA Trading Issues Committee (Committee), a group of 23 appointed members from amongst the CSTA. This committee has an equal proportional number of buy-side and sell-side representatives with various areas of market structure expertise. As of September 2013, the Committee also includes 3 independent members. It is important to note that there was no survey sent to our members to determine popular opinion; the Committee was assigned the responsibility of presenting the opinion of the CSTA as a whole. The opinions and statements provided below do not reflect the opinions of all CSTA members or the opinion of all members of the Trading Issues Committee. We note that there are members of the CSTA and of the Trading Issues Committee whose firms hold equity positions in existing marketplaces as well as the proposed Aequitas exchange.

The CSTA appreciates the opportunity to comment and provide responses to the OSC’s questions regarding the proposal by Aequitas (the “Proposal”). Given the nature of the Proposal, the potential impact on market structure and the variety of constituents on the Trading Issues Committee, we did not arrive at a consensus on many points. However, we have responded to the questions to the best of our ability and have attempted to reflect the differences of opinion that existed within the Committee. Where possible, we have also tried to reflect the reasons behind the various opinions.

General Comments

While responses regarding the specifics of the Proposal varied, there was consensus regarding the fact that speed has become a significant factor in equity markets. Concerns were raised that speed has become overly rewarded due to the interaction between the Order Protection Rule (OPR) and maker-taker pricing adopted by marketplaces. Some members felt that, as a result, there was too much emphasis on competition among marketplaces based on price – specifically the level of rebates. Others did not feel that price was an inappropriate differentiator. However, there was general agreement that considering a full range of alternatives could be beneficial, including those that reward attributes other than speed.

Views on the importance of OPR varied, as seen in the specific responses below, but a number of comments emphasized the need to review the costs and benefits relating to maker-taker pricing as soon as possible. Several Committee members added that if maker-taker is a contributing factor to the problems that Aequitas has stated it seeks to address, it would be better to examine it first before amending other market structure principles and/or interpretations.

A summary of the general themes that emerged from discussions among and comments by Trading Issue Committee members is as follows:

Competitive solutions to market structure issues are to be encouraged. Aequitas' stated goal of seeking to address "predatory" behaviour through a marketplace model is commendable.

Fundamental questions arise regarding the proposed methods for meeting the stated goals of Aequitas. Opinions varied as to whether the Proposal would be effective in addressing the specified undesirable behaviour. Opinions also varied as to the likelihood of it leading to unintended consequences and whether other methods that would not require changes to current market structure or new interpretations would be preferable.

Addressing the effects of speed in a fair and sustainable manner is a key aspect of the Proposal. The parts of the Proposal that directly address the issue of de-prioritizing speed, such as weighted size/time priority, were generally seen as very positive. De-prioritizing SME orders had some support as well, leading some to question why this was not the chosen solution for Hybrid.

Analysis regarding market-making aspects cannot realistically be completed without specific details of the market making program being proposed. A new market-making model is welcome but, as noted in the Proposal, the Aequitas model has not been fully developed yet, making it difficult to comment on the obligations or the possible benefits to the market makers or other participants. In absence of further information, many members felt that giving a market maker allocation priority could be an overly generous incentive. Some also felt that the disconnect between the priority (Hybrid and Dark) and where the obligations apply (Lit) would be problematic.

Forced segmentation requires scrutiny not only due to fairness issues but also because it may lead to information leakage. Some members were concerned that the potential for information leakage in Hybrid could create the possibility for "frontrunning" in other marketplaces; this should be carefully considered. While acknowledging these potential risks, other members pointed out that information leakage theoretically exists in all markets.

The analysis of the appropriateness of restricting access to active orders based on the SME marker should look beyond impact on HFTs. The use of the SME marker is a large point of contention amongst Committee members. Many responders felt that its use as a proxy for HFT was problematic not only due to the definition (which includes many strategies that are not only non-HFT but also clearly not “predatory”) but also to the uneven application and the ability to circumvent its use by slightly altering trading practices. These responders preferred dealing with predatory practices through incentive-based solutions. Others acknowledged the validity of these concerns but felt that the over-inclusiveness was a cost outweighed by the benefits. Further, they felt that issues with the marker could be addressed by IIROC through a tightening of the definition and/or closer oversight.

Responses to OSC questions:

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?

Some Trading Issues Committee members felt that OPR itself should be reviewed (and potentially modified) as soon as possible, and that best execution could be relied upon instead. In some cases, the commenters considered OPR already to be a second level of insurance that the best price would be obtained for clients. Others took the view that the principles behind it remain valid, i.e. that a duty to the market to avoid trading-through better priced orders supports confidence and facilitates virtual consolidation that reduces the impact of fragmentation. This latter view was held notwithstanding the concern that issues with the current structure may be impacting its utility.

Opinions varied as to whether application of OPR could/should be limited. Some members felt that in appropriate circumstances it could be limited and its application left up to the marketplace and its participants. These responders were of the view that any technical difficulties relating to data feeds and routing would be resolvable and balanced by the benefits. Others felt that the utility of OPR is derived from its universal nature, requiring that all visible, automated, continuous market orders be covered (and, therefore, form part of a virtual central limit order book). The members in the latter group felt that the ability to “opt out” could complicate best execution and lead to data feed issues and confusion regarding which orders must be accessed.

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?

The responses to the issues raised in Question 2 depended on the position taken in regards to Question 1. Those who believe that OPR should apply to some degree are split into a group of those who would apply OPR to all visible, automated, continuous quotes (including those on Hybrid), and a group of those who feel that Hybrid presents the appropriate circumstances for opting out of OPR application.

It was generally agreed that while it would benefit Aequitas to require non-SME orders to route to Hybrid’s visible (and therefore best-priced) orders, it could create difficulties. Information leakage and fairness issues arise any time access is restricted in a marketplace; if non-SME orders were required to access Hybrid, these issues might be exacerbated. Some Trading Issues Committee members commented that one particular fairness issue arose from the fact that the entities providing significant contributions to the pricing on which Hybrid quotes were based would not only be excluded from accessing the latter, but would also have a reduced opportunity for fills.

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?

There was no consensus regarding how to display visible Hybrid orders. Some responders felt it should be up to the data vendors to determine how to place Hybrid visible orders into a consolidated display. Others were concerned that such an option would cause confusion and reduce comparability. If Hybrid quotes were to be included, it would be important that extensive work be done to ensure that market participants understood the nature of the partially accessible orders and that data vendors used consistent methodology for displaying these quotes and the resulting trades. Some responders felt that these issues could be resolved via informed choice, best execution and market forces. Others felt that as a market wide issue that could lead to considerable confusion, the regulators should review and, possibly, update the requirements for publishing order information.

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?

This answer definitely depends on whether OPR would apply. If yes, it may be argued that as part of the visible, consolidated quote, it would be difficult to exclude it from the calculation of minimum price improvement under the Dark Rules. However, this could create opportunities for faster traders to move midpoints in dark markets by setting prices in Hybrid where the risk of being filled has been reduced due to the lack of speed on the active side. Alternatively, one of the arguments against OPR applying would be that Hybrid quotes would not set prices for price improvement purposes, avoiding the above issue.

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?

The responses to this question were split based on the relative importance to the responder of setting a precedent relating to segmentation versus the potential of addressing a behaviour negatively impacting trading. Some members were in favour of restricting access for certain strategies, on the basis that they cleanly divided “natural investors” from the non-directional traders that include those employing predatory practices. These responders stated that such a restriction would level the playing field for the former and therefore was consistent with fair access requirements. They added that it would address the perceived prejudice against such orders in the current structure. Other Committee members noted that the goal of eliminating predatory practices, while laudable, should not have the side effect of creating arbitrary precedents. Many Committee members in the latter group were also uncomfortable with restricting “predatory” behaviour without a clear definition of which behaviours were deemed undesirable, as well as the lack of reliable data showing the frequency of such behaviours.

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?

Some commenters stated that the reason access restrictions could previously be argued to meet reasonable

overall cost-benefit analyses with respect to the Canadian markets was due entirely to the unprotected status of the applicable marketplaces due to their structure as dark markets. When considering access restrictions in the visible markets, issues pertaining to the impact on data consolidation requirements and additional routing and market integration complexity all need to be directly considered. It is assumed that those whom Aequitas proposes to exclude are sophisticated entities and therefore unlikely to be negatively impacted in the short term. However, all models should be considered in the context of their impact in the event of success. For example, if Hybrid was to attract large volumes, it would restrict the ability of all non-directional traders (including market makers and facilitation desks) to offset risk which, some members asserted, would have the potential to negatively impact confidence and market integrity. The alternative view was that with large volumes on Hybrid, the positives set out in the Proposal could be more evident.

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

See above. The response to this question depends on 1) whether Hybrid is subject to OPR, 2) the perceived value of a virtual central limit order book with prices accessible to all, and 3) whether the benefits to natural investors from the reduction of the strategies associated with “active” high frequency trading are seen to outweigh the costs.

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

Some members felt that the SME marker, while broad, would capture the predatory and problematic group behaviours that Aequitas is seeking to restrict. These members acknowledged that the SME marker would also capture strategies otherwise deemed beneficial, but that a trade-off was reasonable considering the end goal of servicing natural investors. However, in the absence of alternative markers, it was generally viewed as difficult to identify and police the specified strategies. Without any reasonable alternative, some responders felt that, even if imperfect, the SME marker is a viable proxy.

Other members felt that the fact that the described behaviours couldn’t easily be identified, quantified or policed was an indicator that the SME marker was inappropriate. Since SME is account- and not strategy-based, the unintended consequences could conceivably include incentives to comply with the letter of SME and not the spirit, with a negative impact on the ability to offset risk for a number of traders whose trading is beneficial to the markets (for example, market makers, facilitation desks, interlisted arbitrageurs and other arbitrageurs). While Committee members were sympathetic to the goal of discouraging predatory behaviour, many preferred incentives over exclusions.

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)?

Several responders felt that the combination of broker and market maker preferencing could increase the difficulties for smaller dealers to execute trades and impact certainty of fills, moving farther away from the traditional core values of price/time priority. Alternatively, other responders noted that market making is needed to some degree on all markets and that market makers require some form of incentive. While the existing incentives were generally acknowledged to be either insufficient (i.e. those for formal market makers today, particularly as they relate to less liquid stocks) or potential contributors to problematic market trends (i.e., maker-taker), the lack of information on the obligations and any other incentives planned make any more

complete response difficult. Questions remain whether market maker preferencing would incent market making in the stocks where it is most needed, a frequently cited failing of the current informal market maker model. Further, many responders noted that a key piece of information would be the process for selecting the market makers as it is of critical significance in a model where there is only one market maker per security.

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 noted above, most Committee members felt that it was very difficult to respond to such specifics without further information regarding the model. However, as a general principle, some felt that there were significant fairness issues relating to bifurcating the market-making obligation from the benefit obtained. Specifically, some responders felt there should not be benefits without corresponding obligations on any given market. Others maintained that spanning benefits and obligations across multiple books could be a reasonable approach. Responders agreed that more detail and refinement of the proposed program was needed before its merits could be judged.

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?

Again, further information is required in order to respond fully to this question. Some responders suggested that, in the absence of meaningful formal market making in the Canadian markets, new forms should be supported. Others raised questions as to how the various market making responsibilities would interact, how to measure activity that is not on Aequitas and how meaningful obligations can be imposed on a market maker at a venue that is not the principal market.

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 methodology behind market making assignments was a key consideration for a number of responders. It was viewed by most that it would be impossible for Aequitas to enforce any obligations on a non-member. On the assumption that the end result would be acceptable to the industry and regulators, some responders were satisfied that as with all DEA client trading, the participant would be responsible for ensuring their client met their obligations and that Aequitas would be able to oversee the behaviour of the market makers. Several saw it as a way to bring in some of the major international market making firms.

Alternatively, given the incentives being offered and the potential for them resulting in different behaviours than existing DEA relationships, others felt that it would create new risks. Further, considering the patterns seen to date whereby such clients often seek out dealers with the lightest/faster risk filters, the lowest standards for

accepting DEA clients and the most to gain from attracting new high volume clients (including those with relatively low regulatory capital), some members felt there are potential systemic risk issues. Further detail would be required to respond to the questions regarding IROC member sponsorship or foreign oversight.

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?

Some members took the view that access to foreign market making capability would be of benefit to the Canadian equity markets, while others felt the DEA client market makers would increase systemic risk, as noted above – precisely because they would not be directly overseen by Canadian regulators nor subject to the same requirements as registered investment dealers. We reiterate that without information regarding the specifics it is difficult to answer questions regarding implications, including in terms of fairness and market integrity.

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?

Depending on its level of success, Hybrid may lead to a range of outcomes with respect to the markets as a whole, including little to no impact. With moderate volumes, it could, as Aequitas intends, lead to larger sized quotes at the NBBO by removing the predatory active participants and thus benefit the broader market. It could also potentially protect users from adverse selection and provide an opportunity for a more level playing field for “natural” investors.

On the other hand, some maintain it could make the rest of the market more complex to navigate by protecting passive HFTs in Hybrid from other HFT flow (through the restriction on active SME trading) and arguably creating more opportunities for such flow on other marketplaces. If Hybrid were approved as proposed, the precedent would also theoretically allow other marketplaces to use the Hybrid exemption from OPR to apply access restrictions elsewhere, potentially leading to a proliferation of marketplaces and further fragmentation.

One of the main goals of Hybrid is to exclude a set of strategies relating only to active trading; this would not necessarily deal with quote manipulation on other marketplaces (such as momentum ignition strategies). Some argue that it could allow for more manipulation on Hybrid, since the Hybrid market would only show quotes in the context of the “away NBBO” and would therefore be effectively pegged to those prices. Others supported the Aequitas theory that in combination with its fee structure and matching mechanisms, a restriction on active SME could discourage both active and passive predatory trading. Even if Hybrid were successful, all agreed that predatory behaviours would undoubtedly persist within the market as a whole (including on Aequitas). Further, some responders argue that there is a benefit of having SME trade against SME since in principle those participants can operate at comparable speeds and moderate each other’s behaviour.

Additionally, as noted above, several members commented that where one type of participant is excluded from the active side (in this case, non-directional traders), there is an important risk of information leakage for those directional participants that choose to identify themselves publicly as such.

(Note: some of the above comments implicitly assume that in the Hybrid model, SME trading refers to high frequency trading. As discussed in Question 8, in practice SME would encompass a range of trading, not all of which is high frequency.)

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.

Members were divided on this point as can be seen in the discussions above, which include the different views on benefits and risks.

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?

Many responders believed the cost of adding three new marketplaces would be far too high to warrant a pilot. Others felt that the intended benefits were sufficient to support such an attempt and that it would stimulate further innovations. Some expressed the view that initiatives currently underway (i.e. OPR review) should be completed before making an exception or changing an interpretation that relates to the potential changes to the framework. Others were concerned about the delays inherent in the existing process for regulatory changes.

Some members voiced the concern that facilitating Hybrid without changes to the regulatory framework could have problematic consequences. For example, in their view, orders are or are not visible and a facility that makes something visible but not accessible is contrary to basic principles of our markets.

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 previous question. Several responders felt that a new competitive marketplace aimed at leveling the playing field for natural investors is of sufficient benefit to support flexibility in interpretation of the current regulatory framework. One of the reasons cited was that various alternatives had been considered, and those put forth in the Proposal were determined to be preferable. This was based on the view that while some of the other alternatives have merit or are already present in Hybrid, they would fail to address the active component of the problematic HFT behaviour or would be very difficult to implement in a multiple market environment.

Others noted examples of other methods for dealing with the targeted predatory practices that did not require modification of the established regulatory framework, including 1) reliance on the trade allocation algorithm that is proposed relating to weighted size/time, 2) offering pricing incentives such as lower fees for time in book or maintaining certain order-to-trade ratios and/or 3) offering some form of call market. These members pointed out that disallowing SME liquidity takers protects other SMEs posting passively, not only retail and institutional investors. Some alternatively felt that this allows the "good" SME to remain but discourages the "bad" SME.

Some responders felt that Hybrid should be modified to fit within the established regulatory framework, due primarily to the following: 1) the definition of SME includes a number of account types that require active trading and that are generally considered "good" (such as client facilitation activities) and 2) the restriction against active SME trading would not address the behaviours on other marketplaces, nor the ability to impact prices on all marketplaces (including Aequitas').

The general view was that the stated goals of Aequitas to reduce the impact of speed and level the playing field for “natural” investors are worth pursuing through a competitive offering. The major differences in opinions of Committee members arose when determining whether the Proposal included the right tools to minimize the predatory behaviours it describes. As noted above, some argue there are incentive-based methods that could be applied without conflicting with the current regulatory framework. Throttling, micro-calls, alignment of market data versus fill reports were alternatives suggested by various responders. However, responders were divided on the effectiveness and practicality of these alternatives.

We appreciate the opportunity to comment and respond.

Respectfully,

“Signed by the CSTA Trading Issues Committee”

c.c. to:

OSC:

Mr. Howard Wetston, Chair and CEO
Ms. Maureen Jensen, Executive Director & CAO
Ms. Susan Greenglass, Director, Market Regulation
Ms. Tracey Stern, Manager, Market Regulation

AMF:

M^e Anne-Marie Beaudoin, Secrétaire générale

BCSC:

Ms. Sandra Jakab, Director, Capital Markets Regulation

IIROC:

Ms. Susan Wolburgh Jenah, President and CEO
Ms. Wendy Rudd, SVP, Market Regulation & Policy
Mr. James Twiss, Vice President, Market Regulation Policy
Ms. Deanna Dobrowsky, Vice President, Market Regulation Policy
Mr. Mike Prior, Vice President, Surveillance