13.2.2 Liquidnet Canada – Notice of Proposed Changes and Request for Comment

LIQUIDNET CANADA

NOTICE OF PROPOSED CHANGES AND REQUEST FOR COMMENT

Liquidnet Canada is publishing this Notice of Proposed Changes in accordance with the “Process for the Review and Approval of Rules and the Information Contained in Form 21-101F2 and the Exhibits Thereto.” Market participants are invited to provide the Commission with comment on the proposed changes.

Comment on the proposed changes should be in writing and submitted by May 25, 2015 to

Market Regulation Branch
Ontario Securities Commission
22nd Floor
20 Queen Street West
Toronto, ON M5H 3S8
Fax : (416) 595-8940
marketregulation@osc.gov.on.ca

and

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Comments received will be made public on the OSC website. Upon completion of the Review by OSC staff, and in the absence of any regulatory concerns, notice will be published to confirm the completion of Commission staff’s review and to outline the intended implementation date of the changes.

Any questions regarding the information below should be addressed to:

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Liquidnet Canada proposes to introduce the following change to the Liquidnet Canada trading system:

1. Trading of foreign debt securities

A. Description of the proposed change

Liquidnet Canada ATS is proposing to provide Canadian institutional clients access to the fixed income trading systems operated by affiliates Liquidnet, Inc. (LNUS) and Liquidnet Europe Limited (LNEL) for purposes of trading non-Canadian fixed income securities (also referred to as “bonds”).

Background

In August 2014, Liquidnet Canada’s parent acquired the fixed income trading business operated by Vega-Chi Limited and its subsidiaries, which included a U.S. broker dealer, Vega-Chi US Limited, operating an ATS for the trading of US fixed income securities and a European investment firm, Vega-Chi Limited, operating an MTF for the trading of European fixed income securities. The US fixed income trading system is now operated by foreign affiliate Liquidnet, Inc., while the European fixed income trading system is now operated by Liquidnet Europe Limited. The securities traded on these systems currently include:

a) US and European high-yield corporate fixed income securities

b) US and European investment grade corporate fixed income securities

c) European convertible fixed income securities

d) Emerging markets corporate fixed income securities.

As noted above, the Liquidnet Canada ATS has requested an exemption from Part 6.3 of NI 21-101 to be permitted to offer institutional clients access to the non-Canadian fixed income trading systems operated by affiliates Liquidnet, Inc. and Liquidnet Europe Limited. Until the exemption application has been disposed of, trading capability for current Canadian clients in non-Canadian fixed income securities has been suspended.

Upon grant of the requested exemption and regulatory approval of the proposed change, the Liquidnet Canada ATS will provide institutional subscribers access to the fixed income ATS operated by US affiliate Liquidnet, Inc. and the fixed income MTF operated by UK affiliate Liquidnet Europe Limited for the trading of non-Canadian fixed income securities.

Operation of the fixed income trading system

A customer located in a specific region is a customer of the Liquidnet entity in that region; for example, a customer located in Canada is a customer of Liquidnet Canada and a participant of the Liquidnet Canada ATS.

Each Liquidnet ATS or MTF is responsible for the execution of trades for the market or markets within its region; for example, the Liquidnet Fixed Income ATS is responsible for execution of trades in US fixed income securities.

If a customer located in a specific region transmits an order for a fixed income security traded in another region, Liquidnet's systems record that order as being routed by the Liquidnet entity in the customer's region to the Liquidnet ATS or MTF responsible for execution. For example, for Canadian customers Liquidnet's systems record the order as being routed by the Liquidnet Canada ATS (considered the routing ATS) to the ATS or MTF responsible for execution (the executing ATS). For example, if a customer located in Canada transmits an order for a DTCC-settled fixed income security, Liquidnet's systems record the order as being routed by the Liquidnet Canada ATS to the Liquidnet Fixed Income ATS (the executing ATS).

The Liquidnet Canada ATS, operated by Liquidnet Canada Inc., is a subscriber to the Liquidnet Fixed Income ATS, operated by Liquidnet, Inc., and the Liquidnet Europe Fixed Income MTF, operated by Liquidnet Europe Limited.

Upon grant of the requested exemption and approval of the proposed change, the Liquidnet Canada ATS, will route orders on behalf of Canadian customers for non-Canadian fixed income securities to the Liquidnet Fixed Income ATS, operated by Liquidnet, Inc., and the Liquidnet Europe Fixed Income MTF, operated by Liquidnet Europe Limited.

We use the following defined terms herein:

Defined Term	Definition
Liquidnet Canada	Liquidnet Canada Inc.
LNC ATS	Liquidnet Canada ATS
Liquidnet US	Liquidnet, Inc.
LNUS ATS	Liquidnet Fixed Income ATS
Liquidnet Europe	Liquidnet Europe Limited
LNEL MTF	Liquidnet Europe Limited Fixed Income MTF
Executing ATSs	LNUS ATS and LNEL MTF, collectively
Liquidnet	Liquidnet Canada, Liquidnet US and Liquidnet Europe
ATSs	LNC ATS and Executing ATSs, collectively

The LNC ATS will only participate as a subscriber to the Executing ATSs as agent on behalf of the Canadian customers of the LNC ATS. The LNC ATS does not execute trades. The LNC ATS receives orders from Canadian customers and routes them to the LNUS ATS or the LNEL MTF, as applicable.

Additional information regarding affiliates

Liquidnet US, operator of the LNUS ATS, is a broker-dealer registered with the Securities and Exchange Commission in the US, and is a member of the Financial Industry Regulatory Authority.

Liquidnet Europe, operator of the LNEL MTF, is an investment firm authorized and regulated by the UK Financial Conduct Authority in the United Kingdom as a limited license firm.

Liquidnet Holdings, Inc., based in the US, is the direct or indirect parent company of each of the Liquidnet dealing entities. Pursuant to agreements entered into between Liquidnet Holdings and each of the dealing entities, Liquidnet Holdings provides technology-related services to the dealing entities, including services related to the development, testing and maintenance of Liquidnet's trading systems. The agreements include licensing of technology developed by Liquidnet Holdings.

Vega-Chi Financial Technologies Ltd. (VC Tech), based in Cyprus, is an indirect wholly-owned subsidiary of Liquidnet Holdings. Pursuant to agreements entered into between VC Tech and Liquidnet Canada, Liquidnet US and Liquidnet Europe, VC Tech provides technology-related services, including services related to the development, testing and maintenance of the trading system software provided to Liquidnet Canada, Liquidnet US and Liquidnet Europe. The agreements include licensing of technology developed by VC Tech.

Fixed income customers

Subscribers to the LNC ATS, LNUS ATS and the LNEL MTF consist of buy-side institutional investors and securities dealers. Buy-side institutional investors and securities dealers participate in the displayed order book in the same manner, as described herein. Institutional investors and securities dealers have different means of participation in the negotiation functionality, as described further below. All subscribers are referred to as fixed income customers or customers.

Canadian fixed income customers are direct participants of the LNC ATS and trade through a desktop application provided by Liquidnet Canada. Through the desktop application, customers can enter orders for corporate fixed income securities. A customer also can transmit orders via Liquidnet's API, the customer's order management system, or FIX connectivity.

Location of fixed income customers

Fixed income customers located in the US, Canada, the European Economic Area (EEA) and Switzerland can trade US fixed income securities through the LNUS ATS and European fixed income securities through the LNEL MTF. For Canadian customers, cross-border trades are routed by the Liquidnet Canada ATS to the ATS or MTF responsible for execution, i.e., the LNUS ATS and the LNEL MTF. Only Liquidnet Canada staff, including registered personnel, as applicable, will deal directly with Canadian customers.

Liquidnet provides two methods for executing customer orders:

- Displayed order book
- Negotiation

<u>Displayed Order Book Functionality</u>

Orders displayed through the displayed order book are also referred to as "standard orders".

Order details

When entering an order, a customer must select a security, which is defined by issuer, coupon, maturity and other relevant details.

Customers can execute against existing orders displayed in the system or create new orders. When creating a new order, the customer must input the relevant order details, including:

- Buy or sell
- Order size
- Limit price
- Order expiry.

When executing against an order displayed in the system, the customer only inputs order size, as the price is determined by the contra order, and the order is treated as an IOC (immediate or cancel) order. For investment grade corporate fixed income securities, the price may be expressed as a spread (indicated in basis points) over the relevant government bond benchmark, as opposed to bond points.

Order expiry

All orders expire at the earliest of the following:

- The end of the trading day in the system
- When the trader exits the system
- As designated by the trader through the system.

When creating an order, a trader can designate an order as IOC or specify a time duration for the order (in minutes), subject to all orders expiring at the end of the trading day or when the trader exits the system.

Order size

Order size must be submitted as a notional amount in the currency in which the security is traded.

Limit price

All orders must have a limit price. The limit price must be submitted as a percentage of the par value of the security, expressed in bond points (for example, 98.50 which is 98.5% of the par value). Limit price can be specified up to four decimals.

Order execution and execution priority

The system executes contra-orders with matching security and price, subject to meeting any applicable customer and system minimum size requirements and other applicable order constraints.

Two or more same-side orders are executed based on price and time priority. In the case of two buy orders in a security, the order with the highest limit price has priority of execution; in the case of two sell orders in a security, the order with the lowest limit price has priority of execution. If two same-side orders have the same limit price, the order that was received first by the system has priority of execution.

Display of orders

All "standard" customer orders, which remain anonymous at all times, are displayed to all other system users through the desktop application for the full quantity. The system displays symbol, size, side (buy or sell) and limit price.

Minimum order size

The minimum permitted size for a standard order is 500,000 US dollars, Euros, British pounds or Swiss francs, depending on the currency in which the corporate bond is traded. For securities denominated in other currencies, the currency of the security is converted to US dollars to determine whether an order meets the minimum size requirement.

A customer can request that a Liquidnet Sales rep manually reduce the minimum size requirement for a particular order. In this situation, the Liquidnet Sales rep can contact another customer with a contra-order in the system (the contra) to ask whether the contra would be willing to execute its order for the reduced size requested by the first customer. Liquidnet will not execute an order below minimum size unless requested or consented to by both parties in this manner.

<u>Negotiation functionality</u>

Indication matching functionality

Canadian institutional customers can elect whether or not to participate in negotiation functionality. If an institutional customer elects to participate in negotiation functionality, indications are transmitted directly from the Canadian customer to the Liquidnet Canada ATS and then routed to Liquidnet's indication matching engine.

Contras

When a trader has an indication that is transmitted to the indication matching engine, and there is at least one other trader with a matching indication on the opposite side (a "contra-party" or "contra"), Liquidnet notifies the first trader and any contra. A matching indication (or "match") is one that is in the same fixed income security and where both the trader and the contra meet each other's minimum size, as described below. Customers cannot be matched with opposite side orders having the same customer identifier.

Liquidnet determines matches based on the security identifier provided by each customer.

Minimum size for matching

Each customer has a default minimum size for matching, which applies to all of the customer's indications. Liquidnet automatically sets the default minimum size for each customer at 500,000 US dollars, Euros, British pounds or Swiss francs (depending upon the currency in which the corporate bond is traded), but a customer can modify its default minimum size for all indications upon notice to Liquidnet. A customer can designate any of the following amounts as its default minimum size for all indications:

- 100,000
- 250,000
- 500,000
- 1M
- 2M.

The amounts above refer to US dollars, Euros, British pounds or Swiss francs, depending upon the currency in which the corporate bond is traded. The default minimum sizes for corporate bonds that trade in other currencies are determined by converting the customer's US dollar default minimum size to its equivalent amount in the local currency.

A customer can modify its minimum size for a specific indication, but only prior to receipt of notification of a match on that indication.

Maximum size

For each indication, a customer must set an indication size in its OMS. Liquidnet treats this indication size as the maximum size of the customer's indication.

Matching based on minimum and maximum size

Liquidnet only matches two contras if each side's maximum size is greater than the contra's minimum size. Minimum and maximum sizes are expressed as a notional amount.

Matching stage

Upon receipt of notification of a match, the two matching customers have a five-minute match window during which they can elect to start a negotiation. A negotiation commences when the following conditions have occurred:

- Both customers have elected to a start a negotiation within the five-minute match window
- At the time that the second customer elects to start a negotiation, the customers match on price visibility.

Negotiation price; matching on price visibility

Prior to electing to negotiate, a customer must specify a negotiation price and a price visibility tolerance. The negotiation price is the maximum price (in the case of a buy order) or minimum price (in the case of a sell order) at which the customer is willing to trade.

For two customers to match on price visibility, the following two conditions must be met:

- The buyer's negotiation price plus its price visibility tolerance must be greater than or equal to the seller's negotiation price.
- The seller's negotiation price less its price visibility tolerance must be less than or equal to the buyer's negotiation price.

For example:

- The buyer has a negotiation price of 101 and a price visibility tolerance of 2; the seller has a negotiation price of 103 and a price visibility tolerance of 2; the parties match on price visibility.
- The buyer has a negotiation price of 101 and a price visibility tolerance of 1; the seller has a negotiation price of 103 and a price visibility tolerance of 2; the parties do not match on price visibility because the buyer's negotiation price plus price visibility tolerance is less than the seller's negotiation price.

Adjusting minimum and maximum size

Each matching customer can adjust its maximum order size during the matching stage, except that a customer cannot increase its maximum order size above its OMS indication size.

Customers cannot adjust their minimum size after notification of a match.

A match is broken when one matching customer reduces its maximum size to below the contra's minimum size.

Termination of matches

A match can terminate for any of the following reasons:

- The conditions for commencement of a negotiation described above have not occurred by the end of the five-minute match window.
- One side exits the match.
- One side decreases its maximum size to an amount that is below the contra's minimum size.
- On three occasions during the five-minute match window, both parties elect to commence a negotiation but do not match on price visibility.

Notification to customers upon termination of a match

The system notifies both matching customers when the five-minute match window has expired. When a customer exits a match, the customer must specify a reason; this reason is communicated to the contra. When a match breaks as a result of one customer decreasing its maximum size, the System notifies the second customer that the match has broken because the first customer changed its indication parameters.

When two customers elect to commence a negotiation and do not match on price visibility, the system notifies both customers of this fact. The customers can have two more attempts to establish price visibility by amending their indication parameters. After the third attempt during the five-minute match window, the system breaks the match and notifies both customers that the match is being broken because the customers did not match on price visibility.

Multiple contras; prioritization of match notification

At any time, Liquidnet only notifies a customer of one match with a contra on a particular indication. Prioritization of matching is based on size, and then time, priority.

If a customer matches with multiple contras, Liquidnet displays a match between the customer and the contra with the largest maximum size. If this match does not result in a negotiation, other matching contras similarly are ranked based on largest maximum size. If two contras have the same maximum size, prioritization is based on which contra transmitted its indication to Liquidnet first.

When a match does not result in a negotiation, each side falls to last in priority versus the contra on the particular match.

Notification when one customer has elected to negotiate

When one matching customer elects to negotiate, a notification is sent to the contra. The notification does not provide any details regarding the first customer's price and quantity.

Upon receipt of this notification, if there are more than three minutes remaining on the original five-minute match timer, the match timer is reduced to three minutes.

Negotiation stage

Automatic execution

The negotiation stage commences when two matching customers have elected to start a negotiation and the price condition described above has been met. An automatic execution can occur in lieu of a negotiation if the buyer's negotiation price is equal to (and, in certain cases, greater than) the seller's negotiation price.

Where the buyer and seller have the same negotiation price, an automatic execution occurs at that price. Where the buyer's negotiation price is above the seller's negotiation price by 0.25% (equal to ¼ of a bond point) or less, an automatic execution occurs at the mid-point between the buyer's negotiation price and the seller's negotiation price. Where the buyer's negotiation price is above the seller's negotiation price by more than 0.25% (equal to ¼ of a bond point), the system notifies both customers of this fact and requests that both customers confirm or modify their price.

The execution size is the lesser of the buyer's and seller's maximum sizes.

Display upon commencement of negotiation

Upon commencement of a negotiation, each customer's negotiation price is displayed to the contra. The contra's quantity is not displayed during a negotiation.

At the time that the opening negotiation prices are displayed to each of the two customers in the negotiation, an option appears to enable the two customers to execute the trade in the middle of the two prices (bid and offer). Note that when one side, elects to trade in the middle, the other side is not notified of such intention. If both customers elect to trade in the middle, the trade is executed in the middle of the bid and offer prices entered by the two customers.

If one of the customers amends their opening negotiation price, the option to trade in the middle is no longer available.

Negotiated executions

During a negotiation, either side can accept the other side's negotiation price. Either side also can change its negotiation price during a negotiation. When a customer changes its negotiation price, this is displayed to the contra. An execution occurs when the buying and selling prices meet. Whenever one side changes its price during the negotiation, the timer for the negotiation resets back to five minutes, provided that the previous negotiation price change originated from the other side (i.e., sequential negotiation price changes from the same customer do not reset the negotiation clock).

The execution size is the lesser of the buyer's and seller's maximum sizes.

Minimum and maximum size

A customer can change its maximum size during a negotiation, subject to the limitation set forth above. A customer cannot change its minimum size during a negotiation.

An execution can only occur if each customer's maximum size is greater than or equal to the contra's minimum size.

Canceling a negotiation

Either customer can cancel a negotiation at any time. This ends the negotiation, and a notification is sent to the contra.

A negotiation also terminates if neither customer has modified its negotiation price or accepted the contra's negotiation price within five minutes after the later of commencement of the negotiation and the last negotiation price update by a party.

Termination after an execution

A negotiation also terminates after an execution, but the system can display a new match to each customer if each customer has a remaining quantity on its indication and the other conditions for matching described above are met.

Participation of securities dealers in negotiation process

A securities dealer can elect whether or not to participate in the negotiation process. If a securities dealer elects to participate in the negotiation process, the securities dealer can display a firm order to institutional customers with matching contra-indications. The displayed order shows price and size.

An institutional customer can elect to execute against the securities dealer's order. Alternatively, an institutional customer can elect to commence a negotiation with the securities dealer. The same negotiation process applies as described above, except as follows:

- An institutional customer cannot submit a price that is above the securities dealer's offer price or below the securities dealer's bid price.

- The securities dealer's quantity is displayed to the institutional customer during the negotiation.

Gray Market trading

The Gray Market is the period of market activity between the announcement and pricing of a new issue. All Gray Market orders must be expressed as a percentage of the issue price, which is the official price at which a security will be issued.

Liquidnet can allow two parties to agree on a Gray Market trade prior to the pricing of a new issue, where the parties agree upon the percentage of the issue price at which they will execute. The trade is considered executed upon the pricing of the new issue, at which point the execution price is automatically determined by reference to the new issue price and the percentage of the new issue price previously agreed to by the customers.

In the event that a potential new issue is not subsequently issued, Liquidnet will cancel all Gray Market trades in the issue. This is the same methodology as used in the OTC market for Gray Market trading.

Only standard orders are available for Gray Market trading.

B. The expected date of implementation

It is expected that the proposed change will be implemented shortly after satisfaction of the requirements set forth in Section 3.2(1) of National Instrument 21-101, *Marketplace Operation* (NI 21-101), including the expiration of a 45-day notice period.

C. Rationale for the proposed change

Liquidnet Canada is implementing the proposed change because proceeding in this manner is consistent with the existing regulatory framework within Canada and preferable to routing orders abroad to Liquidnet's fixed income marketplaces and taking the position they are not operating as marketplaces in Canada. The proposed change will also provide Canadian participants with an additional venue for trading non-Canadian fixed income securities.

D. Expected impact of the proposed change on market structure, subscribers, investors and capital markets

We foresee no adverse impact on market structure, subscribers, investors or the capital markets because the proposed change is most consistent with the existing regulatory framework within Canada and relates to the trading of non-Canadian fixed income securities only.

E. Expected impact of the proposed change on Liquidnet Canada's compliance with Ontario securities law and the requirements for fair access and maintenance of a fair and orderly market

We foresee no adverse impact on Liquidnet Canada's compliance with market structure, Ontario securities laws or to requirements of fair access and the maintenance of a fair and orderly market.

F. Consultations undertaken in formulating the proposed change, including internal governance process followed

Liquidnet Canada consulted with certain customers before proceeding with the proposed change. The proposed change was approved by the management of Liquidnet Canada.

G. Whether the proposed change will require subscribers and vendors to modify their own systems

The proposed change will not require any work by subscribers or vendors to modify their own systems. The proposed change is not a material change to technology requirements regarding interfacing with or accessing the marketplace within the meaning of Part 12.3 of NI 21-101.

H. Discussion of alternatives

Liquidnet Canada considered whether or not to implement the proposed change. While some non-Canadian marketplaces receive orders from affiliated Canada based brokers without complying with NI 21-101, there is uncertainty about whether this approach is the optimal course to follow for a regulatory perspective. Since the proposed change is most consistent with the existing regulatory framework in Canada concerning the trading of non-Canadian fixed income securities, Liquidnet Canada intends to implement the proposed change, subject to receipt of regulatory approval.

I. Whether the proposed change would introduce a fee model or feature that currently exists in other markets or jurisdictions

Liquidnet Canada's affiliates in other jurisdictions have not implemented the proposed change because the requested change is specific to the existing regulatory framework in Canada.