

BY ELECTRONIC MAIL: marketregulation@osc.gov.on.ca

October 3, 2013

Market Regulation Branch
Ontario Securities Commission
20 Queen Street West, 22nd Floor
Toronto, ON M5H 3S8

Dear Sirs and Mesdames:

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. ("Comment Paper") published on August 13, 2013.

National Bank Financial Inc. ("NBF") appreciates the opportunity to comment on this Comment Paper. We support the OSC's statutory mandate to provide protection to investors from unfair, improper or fraudulent practices, and to foster fair and efficient capital markets and confidence in capital markets.

In recent years, the regulators and SROs have provided guidance and introduced many regulatory initiatives which have improved transparency such as Order Protection Rule and Electronic Trading Rules. These key regulatory initiatives will benefit investors by enabling them to better understand the Canadian market structure and therefore make more informed investment decisions. It is important to keep in mind that implementing any new regulatory initiatives will require significant resources to adapt industry systems and operations. The regulators should also ensure that the consequences of any regulatory initiative have no adverse impact on the investor. NBF considers that investor protection and fairness must, above all, be the driver for change.

NBF is part of the diverse National Bank Financial Group ("NBFG") which: (i) manufactures mutual funds, owns proprietary distribution channels and supplies services to third party distributors; (ii) operates a discount brokerage firm; and (iii) is an IIROC-regulated investment dealer across Canada. We therefore take great interest in the regulatory initiatives contained in the Comment Paper and their potential impact on investors, the mutual fund industry, the investment industry and financial intermediaries.

Accordingly, our intention is to share our concerns regarding the regulatory initiatives contained in the Comment Paper and our experiences. We trust that our comments will be taken into account during the review process and also provide a positive and productive contribution to the outcome of the regulatory initiatives proposed in the Comment Paper.

The topics discussed in our comment letter are the issues associated with the key aspects of the Proposed Trading Structure (A) Segmentation of order flow; (B) Aequitas market making program; (C) Potential impact of Hybrid on market quality and market integrity (D) Hybrid as a visible market.

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?

We understand that Hybrid is being designed to restrict the ability of HFT firms to enter orders with the intention of limiting potentially predatory strategies and encouraging the posting of passive liquidity by protecting all providers of liquidity against these strategies. This is contradictory to the principle underlying OPR since all visible orders in this case will not be accessible to all parties.

In the interest of price discovery, we do believe that OPR should apply to all visible markets and to all orders displayed on those markets as well as the active non-SME orders that are not restricted from accessing the best-priced displayed orders on Hybrid.

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?

From the information provided, Hybrid does not appear to display the characteristics of a dark market which offers the benefits of dark liquidity i.e., the minimization of market impact costs associated with the execution of large blocks in a visible book, the minimization of information leakage concerns, and the potential to obtain price improvement. So if Hybrid is essentially a lit book denying access to SME orders and excluding the maker taker model, then OPR should apply to Hybrid.

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?

This is a conundrum and one of the circular logic sinkholes that make us question the complexity risk/reward of the proposed marketplace.

If Hybrid is implemented as proposed, the best-priced displayed orders on Hybrid would either already be based on the NBBO, or inside it. Any consolidated quote that an active trader or investor would want to consume should include those prices because they are pertinent. But since those prices are not protected by OPR, the quote would not be a true representation of the actual NBBO and introducing a *second* consolidated quote would be costly and convoluted. The concept of an Away NBBO (and home NBBO) may be counterproductive and confusing to the general investing public as well.

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?

The answer to this question depends on whether or not OPR applies to Hybrid.

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?

Our current regulatory framework facilitates the exposure of liquidity to the widest variety of contra-side participants and supports efficiency in the price formation and discovery process. The application of fair access in this manner also promotes investor confidence in the fairness of the markets by ensuring that all participants are able to access displayed best prices.

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 should either be fully accessible and protected or be classified as dark so that there is a clear delineation between marketplace responsibilities and investor expectations.

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

Hybrid precludes participants whose orders must be marked as an SME order from accessing the passive liquidity. As such, it restricts the ability of certain participants to fully participate in the visible markets and access the best displayed price. Therefore, the segmentation of order flow proposed by Hybrid is not consistent with the fair access requirements for visible markets.

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

The SME marker is not a perfect proxy to identify the behaviours Aequitas seeks to restrict. By segmenting order flow based on orders that use the SME marker, this precludes participants whose orders must be marked as an SME order from accessing the passive liquidity, fully participating in the visible markets and accessing the best displayed price.

While the intent is to restrict participation based on the perceived benefit or harm of certain behaviours, it is possible that some of these activities and strategies might provide benefit, or support beneficial activities. Orders marked SME may also represent orders from accounts used to conduct arbitrage, from market makers when trading in their assigned symbols, from a dealer's principal account that is used to obtain or unwind positions to facilitate a large transaction with a client, or even from an HFT firm conducting trading strategies that might not be categorized by Aequitas as being predatory in nature.

B. Aequitas market making program

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)?

We believe that the approach of providing market makers with the benefit of having some level of priority or participation in orders relative to other investors is justified as it compensates for the costs of having market making responsibilities.

Also, market maker benefits should not distinguish between market making in issuances listed on another exchange (e.g., in the case of TSX listed securities to be traded on Aequitas' order books).

Priority for market makers is not likely to contribute to an increased likelihood that natural investors will be crowded out at the quote. We don't foresee a negative impact on market quality and market integrity if market makers are provided matching priority (after broker preferencing).

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?

Given the lack of transparency in the Hybrid and Dark order books, it would be difficult to impose market making obligations on a market maker. Therefore, providing the benefit of priority to a market maker in the Dark and Hybrid books is not really applicable in this situation.

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?

Market making benefits should accrue with respect to obligations for market making in non-Aequitas listed securities given that market makers play a broader role of assisting with the maintenance of a fair and orderly market and supporting market integrity by acting as a gatekeeper. If a market maker lives up to its obligations for which benefit is being provided within the rules and construct of the regulatory framework, it is fair that they be rewarded for the same.

2. DEA clients as market makers

Question 12: Should DEA clients that are not subject to the direct regulatory authority of the securities regulatory authorities, IIROC and/or the exchange be permitted to act as market makers? Why or why not? How would the following facts affect your response: (i) the DEA client market maker must be sponsored by an IIROC member and (ii) the DEA client market maker must be a member of a self regulatory organization such as FINRA or otherwise subject to appropriate regulatory oversight?

DEA clients that are not subject to the direct regulatory authority of the securities regulatory authorities, IIROC and/or the exchange should not be permitted to act as market makers. Even though the DEA client market makers would be members of the Aequitas exchange (sponsoring dealer) and the sponsoring dealer has offered to account for the actions of the DEA client market maker, it would be a mammoth undertaking for Aequitas to match the regulatory scrutiny offered by IIROC for its dealer members.

Also, there needs to be further clarification provided with respect to foreign regulatory oversight as some U.S. firms that qualify for DEA access may be registered with the SEC but not with FINRA, and therefore lacking exhaustive regulatory oversight offered by an official regulatory body. As well, the foreign regulator may not have rules or compliance requirements applicable to its registrants / members when trading via intermediaries on foreign markets.

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?

We agree with the OSC concern that an un-level playing field could be created between DEA client market makers and registered investment dealers that also seek to become market makers. If both types of market makers would receive the same benefits from Aequitas for performance of duties, they should be subject to the same regulatory standards.

We also agree with the OSC point of view that there might be additional benefits available to DEA client market makers that would not be available to registered investment dealers that are market makers – for example, a DEA client market maker would be able to take advantage of broker preferencing by establishing itself as a client at one or more dealers; it might also have benefits or protections under UMIR as a result of its status as “client” under those rules.

A DEA client market maker is not expected to be a registrant in any jurisdiction in Canada, nor a member of the exchange or directly subject to IIROC rules (including UMIR). So if the DEA client market makers are HFT firms that are located in foreign jurisdictions, this would be contradictory to the Hybrid principle/model of attempting to exclude HFT/SME order flow from their markets.

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?

Hybrid's main value proposition is offering provision of liquidity and protection from certain trading strategies referred to by Aequitas as being predatory in nature, through the proposed segmentation of order flow. In addition, it is offering incentives to market makers and attempting to attract active order flow away from the price formation and price discovery mechanisms of the traditional visible markets.

Our concern is that this will foster more fragmentation rather than less, compounding some of the problems the marketplace is looking to correct. Further, this may further affect investor confidence in the quality of the visible market as a whole, their continued willingness to post limit orders, and what the resulting potential impact might be on liquidity and the efficiency of the price formation and price discovery process.

We agree with the OSC concern that the depth of volume and prices outside of the Away NBBO will not be displayed on Hybrid means that there may be less overall informational value from the displayed Hybrid orders in terms of price formation. As such, Hybrid may create risks to the efficiency of the price formation and price discovery process that takes place on the traditional visible markets, and implications on the liquidity available to those trading in those markets.

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 risks of Hybrid for the marketplace participants in Hybrid outweigh potential benefits to the market as a whole. The primary risk being that Hybrid ushers in increased complexity which is good for sophisticated investors and generally not helpful for longer term investors. Considering that one of the main benefits touted by this exchange is the hope that it will renew confidence in long term investors and issuers, we believe that is a major concern.

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?

The Canadian regulatory framework has experienced much evolution since the advent of multiple marketplaces in recent years. While regulatory evolution is essential for investor protection and to foster fair and efficient capital markets, it is important to weigh the benefits of allowing such an initiative to be approved on a pilot basis as industry participants will incur significant adoption costs in this process.

While the addition of a new marketplace may provide more competition in the industry, it will also result in fragmentation, additional market data costs and increased costs of execution which don't necessarily benefit investors in the long run.

If Hybrid proceeds in its current proposed form, it may necessitate deviating from a number of regulatory principles and objectives that have been fundamental to the development of the current regulatory framework for visible and dark markets which will only add to an already significant regulatory burden on industry participants.

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?

If Hybrid needs to fit clearly within the established regulatory framework for visible liquidity, it must be protected under the Order Protection Rule. Hybrid will not display all resting orders and will employ a pricing mechanism that is largely expected to be reference based. If Hybrid is to be a protected market, it must offer depth of book and contribute its quotes to the Consolidated Market Display. A single virtual consolidated book where all quotes are protected supports visible price discovery and improves market integrity.

If classified as providing dark liquidity, Hybrid would need to apply the Dark Rules, which entail visible order priority, meaningful price improvement and minimum size requirements.

Conclusion

NBF would like to thank you for providing us with an opportunity to comment on this important issue. We look forward to our continued participation in any further public consultation on this topic and would be pleased to discuss our input in greater detail with you. We have expressed our main concerns and our objective is to find solutions that are relevant for, and serve the needs of the Canadian market. NBF and its employees are willing to take a leadership role in this issue participating in consultations with investors, industry participants and the CSA.

Yours truly,



Patrick McEntyre, CFA
Managing Director
Institutional Equity Electronic Services & Trading
National Bank Financial Inc.

Cc:

Julie Eisenstat, Managing Director, Chief Compliance Officer, National Bank Financial Inc.
Zahra Bhutani, Vice President, Compliance, National Bank Financial Inc.