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Market Regulation Branch
Ontario Securities Commission
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Re: Comments on Staff Notice concerning Liquidnet Canada Inc.'s Proposed Targeted Invitations Functionality

Ladies and Gentlemen,

Liquidnet Canada Inc. (Liquidnet) appreciates the opportunity to respond to the specific questions raised by the OSC Staff in the notice published on November 24, 2016 concerning Liquidnet's proposed targeted invitations functionality for equity securities.[1] For the reasons discussed below, we believe that this unique functionality will provide significant cost savings for long-term Canadian investors, will contribute to the effectiveness and efficiency of the Canadian equities market, and does not conflict with the underlying objectives of applicable regulations concerning pre-trade transparency, price discovery and fair access.

I. Background

Liquidnet and its global affiliates operate block crossing systems for institutional investors in 44 countries around the world. A primary component of our trading services is our negotiation system, which enables institutions to negotiate block trades directly with other system participants. Institutions that use Liquidnet reduce their trading costs by avoiding the market impact costs that result when institutional block orders are exposed to high-frequency traders and other short-term traders in the market. Cost savings achieved by institutional investors using Liquidnet are passed on to the hundreds of millions of individual investors globally on whose behalf our clients trade, resulting in reduced trading costs and higher investment returns for these individual investors.

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[1] http://www.osc.gov.on.ca/documents/en/Marketplaces/ats_20161124_sn_liquidnet-proposed-changes.pdf (accessed January 5, 2017) (the "Staff notice"). Liquidnet's Notice of Proposed Change and Request for Comments was also published on November 24, 2016, with the comment period closing on January 9, 2017, http://www.osc.gov.on.ca/documents/en/Marketplaces/ats_20161122_rfc-liquidnet-proposed-changes.pdf (accessed January 5, 2017).

a. The Liquidnet Canada ATS is a unique, block-trading marketplace

The average execution size on the Liquidnet Canada ATS for Canadian equities is 64,042 shares, which is 143 times larger than the average execution size on the Toronto Stock Exchange (447 shares).[2] In terms of average trade value, the average execution on the Liquidnet Canada ATS ($1,737,529) is 275 times larger than the average trade on the TSX ($6,320).[3] These statistics demonstrate that, unlike other Canadian marketplaces, Liquidnet Canada is truly focused on block executions between institutional investors. These are the most efficient types of executions and provide the largest cost savings to long-term investors.

In an October 2016 analysis of costs for trading on European marketplaces, Intelligent Financial Systems Limited (IFSL), an independent third-party consulting firm with expertise in transaction cost analysis, computed that our European affiliate provides an average savings of 84.27 basis points per side for each trade that Liquidnet executes. This equates to an average savings of $11,513 per side for each trade.[4] While comparable data is not available for Canada, our Canadian participants benefit from similar cost savings, which accrue to the majority of Canadian citizens through their investments in mutual funds, pension plans and other mutual investments.

The proposed targeted invitations functionality is consistent with Liquidnet Canada's block-trading focus; in fact, in the US market, the average trade size for executions resulting from targeted invitations (62,000 shares) is significantly larger – 1.6 times larger – than the average trade size for negotiated executions (40,000 shares).[5] While we are proposing a minimum targeted invitations execution size of the lesser of 25,000 shares and 15% of Average Daily Volume (ADV) for Canadian equities, given our experience in the US market, we expect that the average targeted invitations execution will exceed the average negotiated execution size, e.g., 64,000 shares for Canadian equities.

The Liquidnet Canada ATS executes 97% of negotiated trades at the mid-point between the best bid and best offer in the marketplace as of the time of execution.[6]

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[2] Based on IIROC published marketplace data for Q3 2016, http://www.iiroc.ca/industry/marketmonitoringanalysis/Pages/StatisticsInformation.aspx (accessed January 5, 2017).

[3] All currency measured in Canadian dollars unless otherwise noted.

[4] Intelligent Financial Systems Limited (IFSL), "LiquidMetrix Guide to European Dark Pools – October 2016," http://www.if5.com/_LiquidMetrix/!Downloads/DarkPool/LiquidMetrix%20Guide%20to%20European%20Dark%20Pools%202016%2010.pdf (accessed January 5, 2017).

[5] Based on Liquidnet trading data, January 1 through November 30, 2016.

[6] Liquidnet trading data, January 1 through November 30, 2016.

b. The proposed functionality is currently available in 42 other markets and provides significant benefits/advantages relative to traditional dealer IOIs

Liquidnet's global membership has recognized the benefits and advantages of targeted invitations over the traditional dealer practice of seeking liquidity via dissemination of IOIs.[7] These benefits include:

- **Focused dissemination of order information**. For the US market, for targeted invitations where there has been at least one eligible recipient, there has been an average of 2.8 recipients per targeted invitation sent. In contrast, dealers may share client order information with a much larger number of traders/firms while attempting to source liquidity.
- **Recipients have demonstrated bona-fide trading interest**. A targeted invitation enables a trader to limit the dissemination of his or her order information to only those participants who have demonstrated recent contra interest in trading a particular symbol, e.g., the recipient had an opposite-side indication or execution in Liquidnet within a specified "look-back" period. Dealer IOIs may often not be limited in this manner, resulting in unnecessary exposure of client order information.
- **Well-defined, objective criteria for determining recipients**. While seeking liquidity on behalf of clients, dealers may share client order information at their own discretion. In contrast, the recipients for a targeted invitation are determined based on objective targeting criteria, e.g., the recipient had an opposite-side execution in Liquidnet within a specified look-back period. This reduces information leakage and ensures that the process is fair.
- **Traders control targeting criteria**. Targeted invitation functionality allows the institutional trader to maintain control over his or her order because the trader specifies the objective criteria for determining which recipients may be eligible to receive the notification. For example, the sender specifies the maximum number of recipients and the length of the look-back period for a targeted invitation, and may further limit dissemination to recipients who executed against the sender of the targeted invitation in the relevant symbol during the look-back period. In contrast, when a dealer is tasked to seek liquidity to fill a given order, the dealer, not the institutional trader, will often determine how – and to how many recipients – that order information is disseminated.
- **Fully-automated audit trail**. Liquidnet maintains a fully-automated audit trail of all targeted invitations activity, allowing for verification that a targeted invitation is only sent in accordance with an institutional trader's instructions.

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[7] We note that, prior to publication of Liquidnet's Notice of Proposed Change and Request for Comments concerning targeted invitations, multiple participants of the Liquidnet Canada ATS provided written letters of support for the proposed functionality. Liquidnet Canada has provided these letters to OSC Staff.

Liquidnet's global affiliates have implemented the proposed functionality in 42 other markets worldwide, including the United States and twenty-six (26) countries in Europe. More than 430 of Liquidnet's global Member firms have affirmatively opted in to use targeted invitations functionality, with more than $3.1 billion[8] in global value traded to date.[9] Canada is the only Liquidnet market where the proposed functionality has been restricted by securities regulation.

Given (i) the significant benefits to institutional traders using targeted invitations, e.g., the ability to attract latent, block-size liquidity to the marketplace while minimizing information leakage, and (ii) the large size of targeted invitation executions, making this functionality available to institutional traders would provide significant cost savings for long-term Canadian investors without frustrating the objectives of applicable Canadian regulation.

II. Staff requests for specific comments

Question 1: Should Liquidnet receive an exemption from the pre-trade transparency requirements in NI 21-101 for block-sized orders? Should the exemption be limited to orders of buy-side participants? Are there other conditions that should apply?

The pre-trade transparency requirements of sections 7.1 and 7.3 of NI 21-101 are intended to require display of orders that would customarily be posted on a lit marketplace, i.e., where exposure would not negatively impact the order holder. In discussing the rationale and benefits of dark pools and dark orders, the CSA has recognized that block-size orders – like those associated with targeted invitations – would typically not be placed on a lit marketplace:

> Dark Pools were introduced to enable investors to place large orders anonymously without displaying them to the public in order to minimize the market impact costs associated with placing such large orders in a visible book. This could be achieved through institutions trading large volumes among each other anonymously, or through large orders that may have otherwise traded only in the upstairs market, being entered on a marketplace where they can interact with other orders from other investors without being displayed.[10]

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[8] Measured in US dollars.

[9] Liquidnet trading data, January 1 through November 30, 2016.

[10] Joint CSA/IIROC Position Paper 23-405, Dark Liquidity in the Canadian Market, November 19, 2010, at page 10768, http://www.osc.gov.on.ca/documents/en/Securities-Category2/csa_20101119_23-405_dark-liquidity.pdf (accessed January 5, 2017).

As noted in subsections 5.1(3) of Companion Policy 21-101CP, the CSA has also recognized the existence of exceptions to the pre-trade transparency requirements for "special-terms" orders:

> For the purpose of sections 7.1, 7.3, 8.1 and 8.2 of the Instrument, the Canadian securities regulatory authorities do not consider special terms orders that are not immediately executable or that trade in special terms books, such as all-or-none, minimum fill or cash or delayed delivery, to be orders that must be provided to an information processor or, if there is no information processor, to an information vendor for consolidation.[11]

Liquidnet respectfully submits that targeted invitations orders are block-size, minimum fill orders that fall within the meaning of "special-terms orders" excepted from the pre-trade transparency requirements. While all orders on the Liquidnet Canada ATS are subject to a minimum size requirement, the minimum size proposed for a targeted invitations order (lesser of 25,000 shares and 15% of ADV) is different from, and significantly greater than, the minimum matching and negotiation size for the Liquidnet Canada ATS (least of 5,000 shares, 5% of ADV and C$100,000). In this regard, we note that the 2007 Market Integrity Notice No. 2007-002 makes clear that Market Regulation Services (RS) was only intending to exclude a minimum fill condition from being considered a "special terms order" where that condition applies to every order on a marketplace. More particularly, in response to a comment, RS stated that:

> Presently, all marketplaces have established minimum order size requirements for orders entered on their marketplaces (i.e. TSX board lot). RS is of the view that conditions imposed by a marketplace on the entry of an order, such as a minimum volume for the entry of an order, do not make the order a "Special Terms Order" for the purposes of UMIR. A condition that applies to every order on a marketplace cannot be a "Special Terms Order" on that marketplace. [12]

As noted above, the minimum fill requirement set by a trader in connection with a targeted invitation order is not a condition that applies to every order entered on the Liquidnet Canada marketplace, so that should not exclude such orders from being considered "special terms" orders exempt from the pre-trade transparency requirements under the guidance provided in subsection 5.1(3) of the Companion Policy.

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[11] Companion Policy 21-101CP, Marketplace Operation, October 1, 2015, at subsection 5.1(3), http://www.osc.gov.on.ca/documents/en/Securities-Category2/ni_20151001_21-101_unofficial-consolidation-forms-cp.pdf (accessed January 5, 2017).

[12] See Notice No. 2007-002 at pg. 34, http://www.iiroc.ca/Documents/2007/171FFA0B-6384-43F7-B379-42212C8B3D7D_en.pdf (accessed January 5, 2017).

However, should the Staff determine that subsection 5.1(3) of 21-101CP does not apply in this case, Liquidnet respectfully submits that, given the large minimum order size for targeted invitations, i.e., lesser of 25,000 shares and 15% of ADV, and the focused nature of their "display", i.e., average of 2.8 recipients for the US market, an exemption from pre-trade transparency based on such minimum size requirement is appropriate and consistent with the underlying objectives of the pre-trade transparency requirements of NI 21-101.

While Liquidnet's participants are predominantly buy-side institutions, Liquidnet does not believe it is necessary to further limit an exemption to buy-side participants only because dealer participants may also seek to execute a block on behalf of a buy-side customer.[13]

Liquidnet also supports equal treatment of marketplaces and would be in favour of similar exemptions for other marketplaces based on the same terms as granted to Liquidnet.

Finally, in addition to the benefits and advantages of the proposed functionality highlighted above, Liquidnet respectfully submits that the grant of an exemption permitting the proposed functionality is also appropriate because it will aid in levelling the "playing field" between ATS operators and dealers. Currently, a dealer can receive a customer order for more than 50 standard trading units or with a value above C$100,000, and the dealer can communicate that order to multiple, selected potential counter-parties.[14] As outlined above in Section I.b of this letter, the proposed functionality has several advantages relative to this current dealer practice, including:

- Limited dissemination of order information
- Focus on recipients that have demonstrated bona-fide trading interest
- Clear, objective targeting criteria for determining recipients
- Customer control over targeting criteria
- Fully-automated audit trail.

While any exemption from the pre-trade transparency requirements granted to Liquidnet for the proposed functionality would still contain restrictions not currently applicable to dealers, the grant of such an exemption in this case would aid in reducing the discriminatory treatment of ATS operators relative to dealers – to the benefit of institutional investors and their customers.

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[13] However, Liquidnet would also not object to restricting the proposed functionality to buy-side participants if the Staff determines that such a restriction is warranted.

[14] With customer consent, a dealer could also proceed in this fashion for an order that is below these size thresholds.

Question 2: If Liquidnet is granted an exemption from pre-trade transparency, is the lesser of 25,000 shares and 15% of the average daily value the appropriate size?

As noted above, Liquidnet supports the grant of an exemption from pre-trade transparency for targeted invitations functionality based on the proposed minimum size thresholds, i.e., the lesser of 25,000 shares and 15% of ADV. Given the large proposed minimum execution size of targeted invitations relative to the average execution size of Canadian marketplaces, we do not foresee such an exemption having any adverse impact to the marketplace as a whole.

Question 3: Is Liquidnet's proposed functionality consistent with the application of the fair access requirements of NI 21-101?

For the reasons discussed below, Liquidnet Canada respectfully submits that there is nothing unreasonable, unfair or discriminatory about the methodology used to determine recipients of a targeted invitation notification, so the proposed functionality is consistent with the application of the fair access requirements of NI 21-101.

As noted in subsection 7.1(1) of Companion Policy 21-101CP, the requirements regarding access for marketplace participants "do not restrict the marketplace from maintaining reasonable standards for access" to marketplace services. And the purpose of the access requirements "is to ensure that rules, policies, procedures, and fees, as applicable, of the marketplace do not unreasonably create barriers to access to the services provided by the marketplace." Consistent with this stated purpose, targeted invitation recipients are determined based purely on reasonable and objective criteria – there are no subjective factors at play and no unreasonable barriers to participation.

As noted earlier, in many ways, targeted invitations functionality is effectively an extension of Liquidnet Canada's existing indication matching functionality. Where the existing system matches liquidity already present at the marketplace, the proposed functionality is designed to draw latent liquidity to the market by leveraging participating Members' historical trading data, while minimizing information leakage. In both cases, Members are notified of matches/invitations based on their bona fide trading information/activity. Any qualifying Member[15] who has opted in to targeted invitations functionality and has shown a genuine contra interest in trading a particular symbol during a sender-specified look-back period – as demonstrated by a recent execution, order or indication in a given symbol – would receive a targeted invitation notification. Given the block-size orders involved and potential for market impact, it is reasonable to limit a targeted invitation notification to those Members who have

[15] Liquidnet also submits that the qualifying criteria for participating in targeted invitations functionality is objective, fair and reasonable and, therefore, in compliance with the fair access requirements of section 5.1 of NI 21-101.

demonstrated a genuine interest in trading a particular symbol. And, as noted earlier, based on US statistics, notifications have been narrowly focused with an average of 2.8 recipients per targeted invitation sent where there is at least one eligible recipient.

In addition, a plain reading of the text of subsection 5.1(3) of NI 21-101 indicates that a marketplace may indeed implement participation criteria that result in limited access to certain products or services as long as those criteria do not result in "unreasonable discrimination" among participants or "impose any burden on competition that is not reasonably necessary and appropriate." As discussed above, the objective participation criteria proposed for targeted invitations are designed to attract latent liquidity while minimizing information leakage and associated market impact of a block-size order. In this context, these criteria do not permit unreasonable discrimination among participants or impose any unreasonable or inappropriate burdens on competition.[16]

Finally, Liquidnet submits that it is fair and reasonable for a buy-side participant of an ATS to determine how its block-size order is displayed to potential contra-parties – which is how buy-side institutions are currently permitted to operate when interacting directly with dealers. Securities regulations should not unreasonably hinder buy-side institutions in their efforts to reduce trading costs and obtain best execution for their customer orders.

For all of the reasons discussed above, Liquidnet respectfully submits that the methodology proposed for determining recipients of targeted invitations notifications meets the fair access requirements of NI 21-101 because it is objective, reasonable and not discriminatory.

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Liquidnet appreciates this opportunity to comment on the questions raised in the Staff Notice published on November 24, 2016 concerning targeted invitations functionality. Please contact me at (646) 660-8333 with any questions or comments.

Very truly yours,

Thomas P. Scully

Thomas P. Scully, General Counsel

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[16] In response to comments seeking guidance on how the fair access requirements applied to marketplaces that restrict access to certain types of participants, the CSA has stated that the rule "allows a marketplace to give access to certain classes of market participants but requires it to be reasonable when determining access." Supplement to the OSC Bulletin, March 23, 2012, Volume 35, Issue 12 (Supp-1), Appendix A at page 13 http://www.osc.gov.on.ca/documents/en/Securities-Category2/rule_20120323_21-101_amendments-marketplace-operation.pdf (accessed January 5, 2017). This further supports the proposition that a marketplace may provide functionality based on reasonable qualifying criteria.