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Via Email

Market Regulation Branch
Ontario Securities Commission
20 Queen Street West, 20th Floor
Toronto, ON M5H 3S8
marketregulation@osc.gov.on.ca

RE: Application for Recognition of Aequitas Innovations Inc. and Aequitas Neo Exchange Inc. as an Exchange

Dear Mesdames and Sirs:

Barclays Capital Canada Inc. ('BCCI') appreciates the opportunity to comment on the request ('Request') issued by the Ontario Securities Commission ('OSC') on June 27, 2014 concerning the *Application for Recognition of Aequitas Innovations Inc. ('Aequitas') and Aequitas Neo Exchange Inc. ('Aequitas Exchange') as an Exchange*. While we hold an economic interest in Aequitas, the viewpoints expressed here are a reflection of our thinking regarding the Canadian market structure.

BCCI commends Aequitas for taking into careful consideration the points raised previously by the OSC Staff ('Staff') and industry peers regarding its initial proposal. We believe that Aequitas has arrived at a model that fulfills its stated mission of building an exchange in Canada that provides an innovative and cost-efficient marketplace, which protects the interests of all investors and reflects the fundamental purpose of the markets: the efficient allocation of capital between issuer and investor.

In this letter we shall focus on three issues that were raised in the Request, specifically, *Benefits and Obligations of Market Makers*; *Market Makers' Commitment*; and *Application of the Order Protection Rule.*

1. Benefits and Obligations of Market Makers

Recent empirical studies clearly indicate that the implementation of a market making system in equities markets leads to increases in liquidity; reduction of bid-ask spreads, transaction costs, and price volatility; and improvement of daily turnover.[1, 2, 3, 4, 5, 6]

Several leading exchanges, including NYSE, NASDAQ, LSE, Deutsche Börse, and Euronext, have adopted market maker programs to enhance the market quality for their listed securities. It is noteworthy that exchanges around the world have continued to offer formal market maker programs despite the introduction of significant order flow by high frequency trading ('HFT') strategies. This is mainly because HFT participants have no quoting obligations, and depending on their strategies, may be more likely to withdraw liquidity during periods of market volatility[7], when the need for market making is at its greatest. This can exacerbate extreme price movements as dramatically demonstrated in the Flash Crash of May 6, 2010.[8, 9]

The Aequitas proposed market making model builds on the strengths of existing models, and rests principally on three core obligations that are imposed on each Designated Market Maker ('DMM') for its assigned securities in the Aequitas trading books:

- Obligation to provide two-sided continuous quoting in conjunction with a specifically defined NBBO presence requirement in the Lit and Neo Books;

- Obligation to maintain minimum size and spreads around the last price, and maximum quote range deviation from NBBO in the Lit and Neo Books; and

- Obligation to maintain fair and orderly market with reasonable price continuity and liquidity in each book.

These obligations expose the DMMs to essentially two principal risks:

- Adverse selection risk, which is the risk of trading against informed investors, who can more accurately predict how prices will move in the immediate future, effectively forcing DMMs to trade at a negative spread; and

- Inventory risk, which arises from accumulation of significant positions by the DMMs in the course of carrying out their quoting obligations. This exposes the DMMs to market and financial risks, as the value of their inventory fluctuates with prices.

In our view, the foregoing obligations and the resultant risks undertaken by the Aequitas DMMs in order to provide a stable source of liquidity in the interest of all market participants easily justify a limited execution priority, which is currently capped at 15% of the daily traded volume for the security in each Aequitas book.

- ▶ **Staff requested specific comment on whether it is appropriate to have obligations with respect to the Dark Book and dark pools generally and whether it is appropriate to have benefits in the Dark Book but no obligations.**

  In our view, quoting obligations in dark pools would be both unnecessary and inappropriate. It is unnecessary because execution prices in Canadian dark pools are rightfully constrained by the NBBO that is set in the lit markets. It is inappropriate because the resultant price discovery would defeat the purpose of dark pools, which is to limit order information leakage and market impact.

  While Aequitas DMMs would not have specific obligations in the Dark Book, it is important to emphasize that they still have a general obligation to maintain fair and orderly markets across all Aequitas books, including the Dark Book, and that their conduct in meeting this obligation would be subject to regulatory oversight.

It is also noteworthy that UMIR 6.6 (Provision of Price Improvement by a Dark Order) and the requirement that dark pool transactions in Canada occur inside the NBBO ensure that the advantage conferred to the DMM would be contingent on the benefits that are gained by the contra-side participant in terms of price improvement or market impact.

2. Market Makers' Commitment ('MMC')

The MMC feature allows DMMs to commit additional dark liquidity at multiple price levels and in varying quantities within the Lit and Neo Books for securities listed on the Aequitas Exchange only.

- **Staff requested specific feedback on whether the MMC feature provides too great an incentive to the market maker at the expense of the existing orders in the book.**

  The MMC feature enhances the market quality for listed securities and their investors by providing a deeper source of liquidity, and thereby a more robust defense against sharp price fluctuations. As explained in Aequitas's application, "The MMC primarily comes into play in the event there is an incoming active order that would trade through multiple price levels." Given the contribution of MMC to market quality and the associated risks that it poses to the DMM, especially at times of market stress, the limited advantage that is in return conferred to the DMM seems justified.

  In 2008, the United States Securities and Exchange Commission ('SEC') approved a similar feature as part of the NYSE's new market model, which introduced the concept of designated market makers. The feature, known as the "Capital Commitment Schedule" ('CCS'), allows NYSE DMMs to create a schedule of additional non-displayed liquidity at various price points to interact with interest and provide price improvement to orders in the Exchange's system. CCS interest is separate and distinct from other DMM interest in that it serves as the interest of last resort. The SEC found that special advantages conferred to market makers were commensurate with their obligations.[10, 11]

3. Application of the Order Protection Rule ('OPR')

In light of the proliferation of equity trading markets in Canada since the approval of the OPR in 2009, we applaud the Canadian securities regulators' sensitivity to market participant concerns that the costs of the current OPR framework outweighs the benefits of full protection of displayed orders across all Canadian markets. We also recognize that the Proposed Amendments to National Instrument 23-101 ('Proposed Amendments'), including the introduction of a market share threshold ('OPR Threshold') are meant to strike a better balance between benefits and costs of the OPR, without compromising investor protection.

We are however concerned that the Proposed Amendments, particularly the implementation of the OPR Threshold, if applied at the launch point, would effectively stifle any nascent competition and entrench the position of the incumbent exchange as a monopoly with all market participants as its captive customers.

(a) Application of OPR to Neo Book

- **Staff requested comments on whether it is appropriate for a market to be protected where it systematically treats one class of participant differently than another; that is, whether OPR should apply to the Neo Book in these circumstances.**

  In our view, all orders are entitled to equitable rather than equal treatment, as we submit that the *ultimate* goal of OPR is not in fact protection of the order for the sake of the order, but rather protection of the investor.

  As the differential treatment of Latency Sensitive Trader ('LST') orders in the Neo Book, which as Staff noted, "does not unreasonably prohibit, condition or limit access to the Neo Book", brings an important measure of equity to non-LST participants, we are of the view that OPR should apply to the Neo Book, as it does to any other transparent Canadian market.

(b) Application of OPR to New Marketplaces

- **Staff requested feedback on whether to interpret and apply OPR such that it does not apply to any new marketplace that launches in the time period between the publication for comment and implementation of the Proposed Amendments.**

Further, Staff requested comments on specific benefits to the market or costs and complexities that this approach would introduce.

The Aequitas initial and subsequent revised applications were made in good faith under the current OPR framework, which affords its Lit and Neo Books full protection at launch. Therefore, as a matter of fairness and respect for due process, in our view, the Aequitas transparent Books are entitled to protection at launch.

Perhaps more importantly, the Aequitas Exchange does not simply replicate the structure of existing markets, but rather offers a genuine alternative with a unique value proposition that appears unprecedented among capital markets across the world. Therefore, the Aequitas Exchange seems worthy of protection under the OPR as its distinct benefits to investors and market quality may far outweigh the associated costs.

We thank the OSC for engaging market participants in a constructive dialogue and considering our comments regarding this Request.

Sincerely,

Bruce Rothney
President & CEO
Barclays Capital Canada Inc.

References

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