Connor, Clark & Lunn
INVESTMENT MANAGEMENT LTD.

October 8, 2013

VIA ELECTRONIC-MAIL

Market Regulation Branch
Ontario Securities Commission
20 Queen Street West, 22nd Floor
Toronto, ON M5H 3S8
Email: marketregulation@osc.gov.on.ca

Re: Comments in Response to Proposed Structure of Trading Facilities for a New Exchange Proposed to be Established by Aequitas Innovations Inc.

Dear Sirs/Mesdames:

We at Connor, Clark & Lunn Investment Management Ltd. ("CCLIM") are pleased to take this opportunity to provide our comments on the issues raised in the Ontario Securities Commission ("OSC" or "Commission") Staff Notice and Request for Comment Regarding Proposed Structure of Trading Facilities For a New Exchange Proposed to be Established by Aequitas Innovations Inc. ("Notice"). The Notice consists of a background and discussion of issues prepared by the OSC ("OSC Discussion") as well as a discussion and summary of the proposed Aequitas Innovations Inc. ("Aequitas") exchange structure ("Pre-Filing"). The Pre-Filing introduces trading rules which, to-date, have not existed in the Canadian marketplace, so we appreciate the Commission's efforts to engage industry participants at this early stage.

CCLIM is an independent investment management company which manages approximately $26 billion in assets on behalf of pension fund sponsors, corporations, foundations, endowments, mutual funds and qualified individual investors. CCLIM provides equity, fixed income, balanced and alternative investment solutions such as market neutral and high income strategies to clients.

## *I. Executive Summary*

We applaud the Aequitas team in its mission to develop an exchange which "protects the interest of all investors."[1] We share several of the concerns raised in the Pre-Filing regarding predatory trading strategies at work in the Canadian marketplace today and also believe in the value of competition between exchanges. We echo the statement that "[m]ore of the same"[2] is not a solution to exchange competition.

[1] See Pre-Filing, Page 2.
[2] See Pre-Filing, Page 3.

Unfortunately, the proposed structure leaves investors no better served than the under current model. For reasons discussed below, it is a model that adds complexity with no obvious benefits, unreasonably imposes an execution hierarchy that favors certain classes of participants over others, and enables participants to effectively circumvent the dark trading rules introduced just one year ago. For these reasons, we believe there are substantive flaws to the proposed structure that should be addressed before the Aequitas marketplace is permitted to operate in Canada.

### *II. Background on the Aequitas Exchange*

Aequitas is seeking approval for an exchange that consists of three order books: 1) Dark, 2) Hybrid, and 3) Lit. Access and execution priority varies by order book as well as by classification of participant. The proposed exchange incorporates a market maker model, in which market makers have certain quoting obligations in exchange for execution priority benefits.[3]

The characteristics and transparency of each order book are different. Dark very closely resembles the Alpha Exchange Inc. IntraSpread facility with a few exceptions, notably a broader range of participants are permitted to send active orders and execution priority emphasizes market maker orders and de-emphasizes Short Marker Exempt (“SME”) orders.[4] Hybrid—a new concept in the Canadian marketplace—publishes aggregate order book liquidity available at the Canadian National Best Bid and Offer (“NBBO”). Similar to Dark, there are constraints on the type of participant that can access Hybrid liquidity and execution priority varies by participant type. Lit is similar to other Canadian lit venues except it incorporates market makers and execution priority is, again, dependent on the type of participant entering the order.

Subject to a few differences, the Aequitas Dark and Lit markets are relatively similar to other Canadian marketplaces. Hybrid, on the other hand, is a new concept. There is no precedent as to how it integrates with the national market system. Many of the questions raised in the OSC Discussion surround this particular order book.

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[3] Market maker quoting obligations are not yet defined, however, they will consist of a combination of spread, depth, and presence requirements.

[4] The Pre-Filing, which raises concerns about high frequency trading strategies, appears to use the SME flag to identify and isolate High Frequency Trading.

Our comments below focus on elements of the proposed exchange that, we believe, deserve careful consideration and could materially impact the quality of trading in the Canadian market.

### ***III. Segmentation of Order Flow***

The OSC Discussion describes order flow segmentation as it relates to the proposed Aequitas exchange as the prohibition of SME access to Dark and Hybrid. We broaden that description to include the assignment of different execution priorities based on trading style within an order book. Both concepts apply different trading rules to subsets of order flow based on the class of participant. This, in our view, is the fundamental issue that should be addressed. Whether segmentation is in the form of access limitations or improved/reduced execution priority is of secondary importance. We therefore address both SME access (which is limited in Dark and Hybrid) and market maker execution priority in this section.

As a general matter, we approach the concept of order flow segmentation with a cautious eye. A "fair" marketplace is one in which all users are treated equally and participate according to the same set of rules. The Canadian Securities Administrators ("CSA") articulated this clearly in the Order Protection Rule ("OPR") approval order when stating:

> *…participants of all kinds…should be confident that when they enter an order on a marketplace their order will be treated fairly irrespective of the sophistication of the participant or the size of the order.* [5]

When exchanges introduce rules that give users different forms of priority or access based on trading style, the competitive equilibrium is disturbed and the result more closely resembles a private club than a free market. Who is the authority that dictates terms of access to this club? More directly, who defines "good" versus "bad" trading styles? In our view, these decisions are better left to the unbiased judgment of fair competition than an individual or corporate entity, either of which inevitably introduces biases to decision-making.

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[5] CSA Notice and Amendments to National Instrument 21-101 Marketplace Operation and National Instrument 23-101 Trading Rules, November 13, 2009, Page 2.

*A. Order Flow Segmentation as it Relates to Market Making*

The Proposal states that a market making program will "foster liquidity in a greater number of listings and encourage a larger spectrum of firms…to participate as market makers…" Although it is a statement of fact that additional liquidity on lit markets would be beneficial, we question: 1) whether the market maker obligations will be meaningful, and 2) whether the cost of this new found liquidity (if meaningful) is justified. Assuming the quote obligations come at a financial cost to market makers, the Aequitas model assumes this cost will be subsidized by the economic benefits obtained by having priority in Dark and Hybrid. From an investor's standpoint, this is equivalent to robbing Peter to pay Paul. Investor transaction costs will increase as a result of losing priority to the market makers in Dark/Hybrid (unnecessary intermediation) and will presumably decrease as a result of liquidity provision provided by those same market makers in Lit. But the market makers will need to extract a rent to make the overall business worthwhile, which means—on net—transaction costs will *increase* by an amount equivalent to whatever rent market makers extract.

We acknowledge that liquidity provision can have a value proposition if it is meaningful. Imposing a tax on all marketplace participants by giving market makers higher order book priority is not the best way, in our minds, to subsidize liquidity provision. The cost of liquidity should be directly assumed by those who demand it, not by the entire market.

For these reasons, the addition of Aequitas market makers will not improve overall market quality and, therefore, order flow segmentation associated with the model is not justified.

*B. Order Flow Segmentation as it Relates to SME Access*

We appreciate the concerns highlighted in the proposal related to "predatory trading strategies."[6] Creating a separate market where firms implementing predatory strategies cannot participate or are given last priority is one way to address the issue. Unfortunately this approach comes at a cost. First, it is counter to many of the fundamental principles (fair, competitive, and transparent, to name a few) which have governed the development and growth of the Canadian marketplace to date. Second, it undermines the objectives of the OPR and the recently introduced Dark Trading Rules, both of which serve to protect investors and promote price discovery. Beyond the cost, we question whether prohibiting SME access to liquidity really solves the problem. Of the four strategies described as "predatory" in the Pre-Filing (Quote Stuffing, Layering, Order Book Fade, and Momentum Ignition), three are passive strategies and thus would not be addressed by the proposed

[6] See Pre-Filing, page 22.

access limitations. Given the issues access limitations introduce and the fact that introducing them would not materially address the problem, we believe SME access limitations should be eliminated from the proposed Aequitas model.

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Turning to the specific questions raised by the OSC, please find our comments below.

*C. 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?***

Yes, OPR should apply to all visible markets. Transactions should not occur at prices inferior to those made available in the Canadian marketplace.

***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?***

Yes. The Pre-Filing states that Hybrid will publish aggregate order book liquidity available at or within the NBBO. While this may or may not meet the existing technical definition of a "quotation," we view the difference as a matter of semantics. The data is effectively a quotation in that it represents a size and a price, and thus Hybrid is a visible market that should be protected under OPR.

***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?***

We are supportive of the Aequitas proposal to publish *consolidated* Hybrid order book data rather than *individual* order data in the quote feed. For the purpose of integrating Hybrid data with prices from other order books, Hybrid price and aggregate volume data should simply be represented as an "order" at a given price.

***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 reference price for determining whether a dark order has provided minimum price improvement should be the highest available bid or lowest available offer displayed in the consolidated Canadian market, including Hybrid quotes.

*D. Segmentation of Order Flow in the Context of the Principles Underlying Fair Access*

We answer Questions 5 through 8 at once.

Without question, access to all published prices should be available to all users, regardless of trading style. Limiting access introduces tremendous complexities and results in an unfair, uncompetitive marketplace in which price discovery is inhibited.

By limiting access to displayed liquidity, best prices available to a trader are dependent on the characteristics of that specific trader. Let us examine what this means in reality. We must assume that if the limitation proposed by Aequitas is approved, a precedent will be set and other marketplaces will adopt similar models. If the terms of access are different for each marketplace, different users will have different levels of access to each of the various marketplaces. This means that prices available to users are a function of each individual user. Instead of a consolidated Canadian NBBO there will be user-specific NBBOs. When an investor asks for the price of a stock, the response will be "that depends." This is not a model of transparency. How will regulators ensure users are meeting best price obligations? How will best execution be monitored? This is not a marketplace that promotes investor confidence and is not one we should embrace in Canada.

Ensuring all users have equivalent terms of access to published prices is a simple model that promotes fairness, competition, transparency, and price discovery. We believe it would be an irreparable mistake to depart from current access standards.

***IV. Market Making***

Please note our general commentary on market making in Section III above.

***Question 9: What, if any, is the impact on market quality and market integrity if market makers are provided matching priority (after broker preferencing)?***

Unnecessary intermediation will increase resulting in increased transaction costs for investors. Ignoring broker preferencing (which already exists), market maker priority enables market makers to consistently step ahead of all other interest to interact with natural active order flow. That is, market makers are permitted to step ahead of natural orders at a price and force intermediation even when two investors stand ready to interact directly. In our view, this is legalized front-running and will result in higher transaction costs for investors as passive fill rates will decrease and orders will be forced to cross the spread to complete. We do not advocate the need to give investors priority at a price, but we do believe markets should enable investors to compete with all other users on equal ground.

***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?***

Until market maker obligations are defined, it is difficult to assess whether additional requirements are necessary. As discussed in Section III, however, we are skeptical a model that gives order book priority in exchange for certain quoting obligations can be a net benefit to the market. The economics required to make such a model profitable for market makers comes at the expense of all investors. A more desirable model is one in which liquidity providers are directly compensated based on the value of the liquidity they offer. The cost of this liquidity provision should be born directly by those who consume it, not the entire marketplace. Accordingly, market makers should not be given execution priority benefits on any of the three proposed order books.

For ***Questions 11*** through ***13***, please see our previous response.

### *V. Potential Impact of Hybrid on Market Quality and Market Integrity*

For ***Questions 14*** and ***15***, please see our previous comments regarding Hybrid.

***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?***

As discussed previously, we believe there should be substantive changes to Hybrid before it proceeds. If it were to move forward as currently proposed, a pilot program in a limited number of stocks would make sense.

***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?***

Yes. In addition to the elimination of market maker priority, Hybrid should be modified to provide all users with access to liquidity if order book information is published.

### *VI. Conclusion*

For the reasons set forth above, we encourage significant adjustments to the proposed Aequitas model before proceeding. It is one that adds complexity to the trading landscape and promotes and protects market maker intermediaries at the expense of investors. This complexity and cost is unnecessary. Instead, we support a trading structure that allows all users to participate according to the same rules, thus enabling traders to compete on equal ground. A fair and free market will naturally compensate those who provide value and weed out those who do not.

Should you have any further questions, please do not hesitate to contact either Jenny Drake (jdrake@cclgroup.com) or Don Towers (drtowers@cclgroup.com).

Respectfully submitted,

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