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September 27, 2013

Re: Aequitas Innovations Inc. – OSC Staff Notice and Request for Comment

Dear Sirs and Madams:

TD Securities welcomes the opportunity to comment on the OSC Staff Notice and Request For Comment regarding the proposed structure of trading facilities for a new exchange proposed to be established by Aequitas Innovations Inc. (Notice).

TD Securities is a leading securities dealer in Canada and the number one ranked block trader in Canadian equities and options based on dollar value and shares traded. TD Securities also acts as the executing dealer for TD Waterhouse, the largest discount brokerage firm in Canada.

We strongly support innovation and competition in the Canadian capital markets and we believe the Aequitas proposal has merits in driving innovation and addressing shortcomings in the Canadian market structure framework. However it is our view that the fundamental issues in the regulatory framework should be solved first before introducing new market models. We are concerned that adding a new model into a flawed framework will not fix the framework, but will only add to complexity, fragmentation, operational risk and a lack transparency.

We see the core shortcomings in the market structure framework as being:

1. Sub-penny issues arising from the make/take (and inverted) fee models
2. Market data pricing model
3. Anti-competitive implications of the Order Protection Rule

We prefer to see the fundamental problems addressed first, with time allowed for the industry to adapt, and then evaluate afterwards if new market models are still necessary.

Make-Take Fee Model

The make/take model is the primary driver of the fragmentation and intermediation seen in today's market. The model is in direct conflict with regulations on tick increments and the prohibition on payment for order flow, which creates economic distortions and agency issues. In our opinion these conflicts should be addressed before new market models are introduced.

The minimum tick increment rule is in place to encourage participants to post resting orders without the risk of intermediaries gaining priority over their orders for a *de minimis* amount of price improvement. The make/take model subverts this rule by introducing sub-penny price levels, which are embedded in the marketplace fee rather than in the price itself. On the surface the make/take model conforms to the minimum tick rule since the notional trade prices are unchanged, but economically the model is equivalent to sub-penny tick increments.

The make/take model encourages marketplaces to launch multiple market books, each at a different fee level, and enables intermediaries to gain priority over resting orders for a *de minimus* amount by posting on an alternate market book. The net result has been a rapid growth in fragmentation and intermediation, and a crowding out of natural resting orders. On page 15 of the Request for Comment, the CSA notes that certain aspects of Aequitas's proposal "could negatively impact investor confidence if the likelihood of an investor achieving a fill on its passive order is diminished…" This negative impact already exists in the visible market as a result of sub-penny price increments created by the make/take model.

Canadian regulators have acted to prevent this type of intermediation from occurring in dark pools but have ignored the same effect in the visible market. The implementation of Dark Rules has not improved the likelihood of natural resting orders to be filled in the visible market, as the same intermediaries continue to step ahead of natural resting orders for a *de minimis* amount of price improvement on alternate marketplaces.

What makes the model even more problematic is the make/take payments are not consistently passed to the end client. In general HFT clients receive the rebate payments while natural institutional and retail clients do not. This distorts the trading economics between market participants and creates an agency problem for dealers, as discussed in the excellent market structure paper recently published by Angel/Harris/Spatt[1]

Aequitas proposes to address the intermediation problem by segmenting natural and HFT participants (using the SME marker as a proxy for HFT). While this approach is interesting, we do not see how it will reduce intermediation in the Canadian market as a whole if the fundamental problems with make/take are not addressed first.

Market Data

After several years of discussion and debate, there has been no resolution to the problem of spiralling data and connectivity costs faced by industry participants in Canada, commonly referred to now as "the captive consumer problem." In short, the captive consumer problem arises from the fact that existing rules protect all visible quotes on recognized marketplaces. As

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[1] "*Equity Trading in the 21st Century: An Update*", June 21 2013, James J. Angel, Lawrence E. Harris, Chester S. Spatt

such, dealers and participants are forced to connect to all these venues as well as pay fees to access marketplace data, even if this data set does not meaningfully contribute to price discovery.

In contrast, the US model for data allows participants to subscribe for one feed at a fixed cost from a central processor. Any new markets that contribute prices to this US feed (known as the SIP) earn a portion of market data revenue at the expense of the other marketplaces' data revenue. In other words, the size of the market data pie in the US is fixed.

We understand from the Aequitas proposal that this new initiative will eventually include solutions to the spiralling data cost problem in Canada. We look forward to learning more about this opportunity to lower data fees. However, we encourage the CSA to follow up its recent concept release on market data costs with additional industry dialogue in order to address this issue in the near future.

Order Protection Rule

The Order Protection Rule (OPR) was implemented to integrate multiple marketplaces and to ensure that better priced limit orders are not traded through, regardless of the marketplace those orders are posted on. An unintended consequence of OPR is it grants marketplaces monopolistic power, as Participants must connect and subscribe to all marketplaces to ensure their orders do not trade through any better priced quotes. The rule enables smaller marketplaces, which would otherwise be economically unviable, to sustain themselves on connectivity and market data fees despite adding little value to price discovery or liquidity.

The rule also creates operational complexity for Participants since they must maintain connections to smaller marketplace despite rarely trading there, which adds operational risk for the Participant and the industry as a whole. In our opinion, marketplaces should first prove themselves with a compelling market model that attracts liquidity before being granted the privileges that come with being a protected market.

Aequitas proposes relaxing the Order Protection Rule, but for the purpose of segmentation of order flow rather than addressing the small marketplace problem. We see these as separate and distinct issues within OPR and prefer that the problems with small protected marketplaces be resolved first before the implications of segmented order flow are considered.

Background on Segmentation of Order Flow

The market structures for foreign exchange, fixed income, swaps, and other asset classes besides equities have evolved into a wide range of models ranging from purely bilateral for OTC markets to multilateral request-for-quote systems. The spectrum of models can be classified as:

- One-to-One (bilateral OTC negotiations)
- Many-to-One (dealer markets, US wholesaler ATSs, FX and Fixed Income RFQs)
- Restricted Many-to-Many (some US dark pools, US Swap Execution Facilities)
- Fair Access Many-to-Many (Continuous Limit Order Books in visible equity markets)

These market structures have evolved to meet the needs of market participants and to enhance market efficiency by allowing private price negotiations between counterparties. The one-to-one, many-to-one and restricted many-to-many models are all based on segmentation of order and

trade information rather than fair access. Private negotiations enable trade prices to be aligned with risk while managing information leakage, which is a key advantage over the fair access model.

The primary factor in the success of US dark liquidity was the introduction of private negotiations, made possible by the removal of fair access requirements. While we see much room for improvement in the US framework, their equity markets are inarguably the most liquid and most efficient on the globe, partly as a result of their diversity of market models.

A shortcoming of the fair access model is that liquidity providers are at risk of trading with counterparties who may have a short term information advantage, generally described as toxic order flow. In response, liquidity providers widen their spreads to compensate for trading losses (we consider spread to be sum of the visible spread plus any marketplace rebates). Spreads on a fair access marketplace are wider than they would be otherwise on a marketplace that restricts toxic active orders. A key question in the debate over fair access is whether it is fair for natural retail and institutional clients to pay wider spreads than necessary as a result of their orders being co-mingled with more toxic active orders.

US dark pools are able to offer tighter spreads to their participants because of their ability to exclude toxic active orders from accessing the pool. Aequitas proposes to take a similar approach with their Hybrid lit book by excluding active SME orders (as a proxy for HFT) with the goal of reducing both the displayed spreads and take fees for retail and institutional orders.

Relaxing the fair access requirement on a visible marketplace is a radical departure for Canadian market structure and has the potential to introduce extreme fragmentation and complexity as other marketplaces add their own segmented order books. In our opinion, we should learn from mistakes made in the US and adopt a few key principles before considering changes to the fair access rule. These principles include:

1. Pass the economic benefits of order flow segmentation to the end client in all cases. The current US and Canadian models embed the trading economics into the marketplace fee (or payment-for-orderflow) which allows intermediaries to capture the benefits of order flow segmentation rather than the end client. In our opinion the trading economics should always be included in the trade price in the interest of transparency and fairness.

   Prohibiting marketplace rebates and payment-for-orderflow is a natural consequence of this principle. Australian regulators have been the first to recognise and enforce this principle and we applaud their leadership.

2. Re-evaluate tick increments and the definition of meaningful price improvement. The economics for order flow segmentation are on the 10 mil to 50 mil level, in particular for high volume, low price securities. Ten mil price increments would be necessary in order to include the trade economics in the trade price for these securities.

   We note the current one cent tick increment does not scale well for low priced securities. In basis points the one cent increment is 100 times larger for a $1 security compared to a $100 security, which suggests 10 mil increments may be viable for liquid securities in the $1-$10 range. However any changes to minimum tick increments will need to be weighed against the ability of intermediaries to step ahead of resting orders for a *de minimus* amount of price improvement. This could be achieved by restricting 10 mil increments to only highly liquid low price securities.

3. Maintain fair access for liquidity providers. A major driver in the extreme fragmentation of the US market is the fact that both liquidity takers and liquidity providers can be excluded from dark pools. We value competition among liquidity providers and respect that all providers should have fair access to active orders. Any changes to the interpretation of fair access principles should be limited to active orders only to promote competition among liquidity providers and to limit fragmentation.

4. Visible order books with segmented access should not be protected. There is a risk that relaxing the fair access rule will encourage a large number of new order books to be created as each marketplace launches their own version of Hybrid and experiments with variations on exclusion criteria. These marketplaces should be able to succeed or fail on their own merits without being subsidized by mandatory connection fees or market data fees. A non-protected status will also reduce the operational complexity for dealers choosing not to participate in these markets.

5. Consider randomizing the latency for order and fills, or introducing continuous call auctions to improve liquidity and to level the playing field relative to HFT participants. We see the race to zero latency as being harmful to the industry as a whole, with an unjustifiable level of resources being dedicated to marginal technology improvements for the benefit of a select few. There are diminishing returns in taking continuous trading down to infinitesimally small time intervals. A more rational approach would be to move to a call auction model to focus liquidity on a point in time, especially for illiquid securities.

In our opinion, these principles should be debated and adopted before considering changes to fair access rules. Implementing Hybrid without these principles will put us on the same path of extreme fragmentation and market complexity that the US had gone down, but without the full benefits of their diversity of market models.

OSC Staff have asked a number of specific questions in the Notice. Our responses follow below:

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?

In cases where order flow is segmented on a visible market it is impossible to apply OPR since the restricted counterparty will be unable to clear the quote to prevent a trade-through. We note that it is possible for the marketplace to avoid a trade-through violation by automatically re-pricing the quote to the away NBBO when it is accessed by a restricted counterparty, but this would add complexity for clients placing resting orders who would need to consent to the automatic re-pricing.

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?

OPR should not apply to Hybrid in either case. Allowing order flow segmentation in the visible market will significantly increase the number of visible order books once other marketplaces launch their own versions of Hybrid. These order books should be allowed to succeed or fail on

their own merits without being subsidized by captive market data and access fees. Participants should have an option to connect to restricted markets to manage their operational costs and risk.

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?

Market participants should be able to independently define the marketplaces represented in their consolidated quotes to manage their market data costs. As an unprotected marketplace, Hybrid should be excluded from a mandatory consolidated display.

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?

Hybrid quotes should not be included in a reference price for dark markets. Hybrid quotes may be tighter than the Away NBBO as a result of order flow segmentation. Including the Hybrid quote in the dark pool reference price would allow a restricted counterparty to access more favourable pricing in a dark pool which they would not otherwise be entitled to receive.

Question 5: How should fair access requirements be applied with respect to access to visible marketplaces?

In our opinion it is premature to relax fair access requirements for visible marketplaces without first addressing fundamental issues in the current regulatory framework. Allowing visible marketplaces to launch segmented order books will create extreme fragmentation, complexity, operational risk and a lack of transparency unless the fundamental issues of the make/take fee model, minimum price increments and small marketplace protection under OPR are resolved first.

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?

See above discussion on segmentation of order flow.

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

The current interpretation of fair access requirements would need to be relaxed to support the Hybrid model.

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

The SME marker is one of many possible ways of restricting counterparties. We expect that other marketplaces will propose their own versions of Hybrid with a variety of exclusion criteria if Hybrid is approved. In a free market, these order books will succeed or fail based on the effectiveness of these criteria.

The SME marker has some shortcomings as a criteria, as the marker may be avoided by bundling an HFT strategy with a directional portfolio, and SME also captures many trading activities which are not predatory in nature. We recognise that no criteria can be designed to be perfect and we support the freedom of marketplaces to develop competing proposals.

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

Providing matching priority (after broker preferencing) is not a bad idee, but should be limited to some percentage of the incoming order to allow lower priority orders to continue to participate. On the TSX for example, market maker participation is limited by the MGF size which allows lower priority orders to be filled. The current proposal is exceptionally generous to market makers and it is impossible to say if this value is commensurate with obligations without the obligations being defined.

Any market making program should be designed to recognise that the securities most attractive to market makers (high volume, low price securities) are in the least need of additional liquidity, and those most needing liquidity are also the least attractive to market makers. Market makers should be assigned obligations on a package of securities which include a small number of high volume securities and larger set of illiquid names.

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?

We do not see market making obligations or priority as being necessary on the Dark or Hybrid books.

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?

Yes, we see additional liquidity outside the listing exchange as being beneficial for thinly traded securities.

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 have become de-facto market makers on Canadian securities through the TSX ELP program and low latency access to ATSs, but currently carry no obligations to make markets on illiquid securities or to maintain continuous two-sided quotes. We agree these DEA clients should carry market making obligations if they receive preferential pricing or queue priority. We consider sponsorship by an IIROC member combined with regulation by a foreign jurisdiction signatory to the ISOCO Multilateral MOU to be appropriate criteria for DEA clients to be eligible as market makers.

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?

The primary criteria for assignment of market making obligations should be the ability to fulfill those obligations. We do not see an un-level playing field being created if both eligible DEA clients and registered investment dealers are able to apply for market maker assignments.

Question 14: How might Hybrid impact the quality and integrity of the visible market as a whole?

We expect Hybrid will drive the creation of a diversity of market models which will improve liquidity and market efficiency for the visible market as a whole while increasing complexity and fragmentation, similar to the US experience with dark pools. Spreads can be expected to narrow in restricted access markets and will widen in full access markets to align with the relative toxicity of counterparties.

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.

If Hybrid were introduced into the current regulatory framework the risks would outweigh the benefits, as other marketplaces would immediately launch restricted access order books leading to an extreme level of complexity, fragmentation and non-transparent trading economics. The fundamental issues of make/take fee models, minimum price increments, fair access, OPR and market data need to be addressed first before Hybrid can be considered.

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?

See above discussion on segmentation of order flow. We prefer to see the underlying regulatory framework issues addressed first before moving ahead with a pilot of Hybrid. Launching Hybrid as a pilot will incur the same costs for development, testing, support, connectivity and operations as a full launch of Hybrid, but will not directly solve the fundamental market structure issues.

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?

Modifying Hybrid to fit clearly within the established regulatory framework will eliminate the value proposition of Aequitas and reduce it to being a redundant and unnecessary duplicate of other visible markets.

We appreciate the opportunity to comment on the OSC Notice and Request For Comment on the Aequitas Proposal and we would welcome a meeting with OSC Staff to further discuss our views.

Respectfully,

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