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## Aequitas Innovations Inc.

*Innovation for Fair Markets*

Aequitas [ekwitæs]: Fairness in Latin

**“The Democracy of the Markets is more of an Illusion than a Reality”**

CNBC – Free Markets Fair Markets – June, 2013

Aequitas Innovations Inc. is a Canadian corporation that will seek to apply innovation, technology and competition to promote fairness in the markets and fairness towards the traditional investors and issuers – the cornerstones of our economy.

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## 1. Introducing Aequitas

### a) The Initiative Leaders

The Mission Statement of Aequitas Innovations Inc. (“Aequitas”) is:

***“To create an exchange in Canada that provides an innovative and cost-efficient marketplace which protects the interest of all investors and reflects the fundamental purpose of markets: the efficient allocation of capital between issuers and investors as a central force driving the Canadian economy”***

Aequitas was founded by a group of stakeholders who believe today's equity marketplaces do not provide the public with the fairness, efficiency and choice that encourage confidence and participation by investors, issuers and dealers. The concentration of services, the dominant market structure model and lack of innovation are at the heart of this problem.

Our stakeholders include professional money managers, pension funds, sell-side institutions and issuers who believe choice, driven by competition and built on differentiation and innovation, is acutely needed in Canadian equity markets. The lack thereof threatens the long-term health of our equity markets, and therefore, ultimately, economic growth and employment. In Aequitas, market participant leaders have joined forces with the goal of establishing a commercial enterprise whose prime objective is to more equitably serve the collective needs of investors, issuers, and intermediaries and, as a result, the public at large.

### b) The Rationale

One of the consequences of the global phenomenon of demutualization of stock exchanges has been that exchanges and alternative trading venues are now geared to maximize their short-term profitability at the expense of longer-term objectives and the needs of their most important stakeholders: investors and issuers.

Today these venues cater to volume generating electronic trading firms (High Frequency Traders – “HFTs”) and increasingly take investor, issuer and dealer participation for granted. This continues despite low investor confidence, companies’ capital raising challenges and the cost challenges of many dealers focused on servicing them.

This situation has been exacerbated in the Canadian context by the recent move towards a large concentration of services in a single marketplace: The TMX Group<sup>1</sup>.

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<sup>1</sup> The TMX Group accounts for approximately 85% of the equity trading, 100% of the trading of exchange traded options and futures contracts, 100% of the clearing of equity, fixed income, and derivatives instruments, 95% of the equity listings and over 85% of the market data fees in Canada.

In our view, competition is the best way to foster efficiency and innovation, thereby enhancing confidence in Canada's capital markets. For competition to be effective, however, it should not be based on the models and principles that characterize current marketplaces. More of the same will not address the issues that exist in today's markets – it will only lead to additional imbalance, costs and inefficiencies.

Aequitas believes there is untapped opportunity to leverage technology and competition while promoting liquidity, fairness, cost savings and – most importantly – investor confidence.

This document introduces Aequitas and its value propositions at a high-level, and also provides a more detailed view of the key market structure solutions that we have identified to fulfill our mission. Over time and after discussions with investor, issuer and dealer representatives, other innovative solutions and further details will be shared leading to an integrated value proposition that will be published for comment in Aequitas' formal application for recognition as an exchange.

### **c) Achieving The Mission**

Within the context of today's markets, we offer a uniquely differentiated and innovative vision of how a marketplace should function and whom it should serve. Specifically, Aequitas proposes:

- An ownership and governance structure built with the core founding principle of servicing investors and issuers;
- Advisory committees that give investors and issuers a strong voice;
- Solutions designed to promote fairness and encourage investor confidence in Canada's equity markets, while providing issuers with a capital formation toolset that will support their success and growth;
- Technology that facilitates market quality by helping eliminate the most prevalent predatory trading strategies;
- A plan to promote sustainable market making which will support the liquidity needs of investors and issuers; and
- Innovative and affordable services positioned to place meaningful competitive pressure on incumbent players.

## 2. The Aequitas Strategy

### a) Innovation to Address Challenges

Aequitas has developed new approaches designed to bring meaningful competition and choice to Canadian marketplace participants. Aequitas will offer a highly differentiated alternative to the dominant market structure model that will cater to the needs of traditional investors and issuers, protect against predatory and opportunistic trading strategies, and enhance the capital formation process. Our approach will include:

- New market structure solutions;
- A plan to foster sustainable market making;
- Best in class Smart Order Routing (“SOR”) services;
- A plan to address the cost issues of marketplace users; and
- Capital formation enabling solutions in tune with issuers and investors.

### b) A new Approach to Market Structure

The Aequitas market structure approach seeks to apply innovation to address interests that are not currently being served and market confidence issues. Until recently, many people believed that technology would only make markets more efficient. Now, with the benefit of time and experience, they understand that not all changes have been positive.

Some observers position HFTs as specialists in “liquidity provision” – in effect, today’s market makers. However, despite advantageous technological access and financial subsidies, these players have (in contrast to designated market makers) no obligation to the market. Often they compete for the same liquidity as investors.

We believe today’s markets fall short of the public’s expectation that our industry ought to use technology and competition to improve markets. Rather, some use it to extract an unconstrained toll from investors, large and small. These trends also discourage true market makers from providing liquidity – particularly in small cap names where it is most needed.

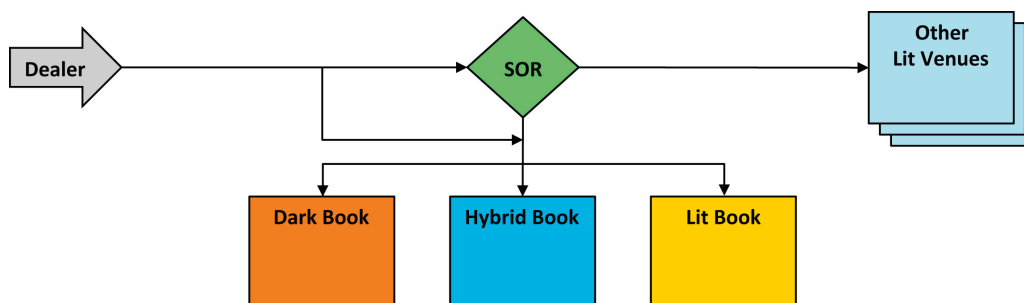
Aequitas proposes solutions to these global market challenges that will bring choice to groups of market participants who are disadvantaged in the current environment. We believe these measures are critical to restore balance and will promote price discovery, liquidity, competition, innovation and market integrity.

Aequitas’ proposed market structure combines multiple order books, innovative approaches to matching priorities and market making, as well as the prevention of inappropriate trading strategies as the foundation of an eco-system that:

- Recognizes the role of healthy market making – with benefits *and* responsibilities;
- Discourages strategies that are damaging to principles of fairness and market confidence; and
- Offers a viable alternative to rebate incentives and maker-taker pricing which Aequitas believes has negatively impacted market quality.

The following diagram illustrates the high-level marketplace design of the Aequitas eco-system:

**Diagram 1: The Aequitas basic Market Structure Eco-system**



The foundation of our proposed market structure solution is the establishment of three core order books: Dark, Hybrid and Lit. Each is designed to serve a separate yet integrated role in the Aequitas eco-system. Integrating these order books with other marketplaces is a SOR solution that we discuss in more detail in Section 2(d).

Next, we will briefly describe the proposed structure and objectives of each of the three core order books.

### I. Aequitas Dark

Similar to existing dark pools operating in Canada today, Aequitas Dark would offer no pre-trade transparency. Consistent with Canada’s dark rules, matching would occur at mid-point, or at least one standard price increment from the National Best Bid and Offer (“NBBO”), at regular price increments, or at the NBBO for active orders provided they are for at least 50 standard trading units or \$100,000 in value.

Actively removing liquidity will only be available to retail and qualifying institutional parties. The objective of this restriction is to prevent predatory trading strategies and

encourage quality resting liquidity. To implement this limitation, the Dark Book will restrict “Short-Marking Exempt” (SME) participants<sup>2</sup> from taking liquidity.

There are no proposed restrictions on who may post liquidity in Aequitas Dark. Furthermore, parties posting in the dark book will have the option to:

- Specify minimum quantities on counterparty size and fill size;
- Interact only with active retail orders<sup>3</sup>;
- Interact with contra resting liquidity; and
- Offer additional liquidity (“size up”) in the event of a passive-passive match.<sup>4</sup>

The proposed matching priority is as follows:

1. Price
2. Broker
3. Market Maker for the security<sup>5</sup>
4. Weighted Size/Time<sup>6</sup>

The weighted size/time matching prioritization model answers implicit fairness issues associated with time-dominant matching mechanisms. Aequitas believes this system will be more equitable, foster larger and more reliable resting orders while, at the same time, deflecting predatory liquidity provision strategies.

The Aequitas Dark fee model will *not* be a maker-taker fee model.

Aequitas Dark has been devised to encourage natural passive liquidity and market making while restricting SME participants from taking liquidity in a predatory fashion. Its proposed “size-up” functionality is being offered to allow institutional participants to leverage dark algorithmic strategies to marshal liquidity residing in their blotter or on another market with the goal of contributing to size discovery – consistent with an appropriate role for dark books.

## II. Aequitas Hybrid

The Aequitas Hybrid book<sup>7</sup> is so named as it shares certain properties of both lit and dark books. It would only display liquidity and permit trading to occur at or within the NBBO at

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<sup>2</sup> Generally arbitrage accounts, an account of a person with Marketplace Trading Obligations (Market Maker), or a fully automated account that holds nominal positions at the end of each trading day (see IROC UMIR 1.1 for full definition).

<sup>3</sup> Further consideration will be given into refining the definitions to address any issues regarding compliance.

<sup>4</sup> Aequitas has filed a patent for its “size-up” functionality.

<sup>5</sup> We discuss the rationale for this priority functionality further in Section 2(c).

<sup>6</sup> Aequitas has filed a patent for its Weighted Size / Time matching prioritization model.

<sup>7</sup> Aequitas has filed a patent for its Hybrid Book.

regular price increments. Further, it would only display aggregated liquidity (number of shares) available at each price level – with no individual resting order information.

Aequitas Hybrid would restrict SME participants from removing liquidity. The rationale here is the same as in Aequitas Dark: to suppress predatory trading practices and promote quality resting liquidity – in this case visible liquidity. All participants will be free to post liquidity – notably, with the confidence that they are protected from aforementioned practices.

The proposed matching priority is as follows:

1. Price
2. Broker
3. Market Maker for the security<sup>8</sup>
4. Weighted Size/Time<sup>9</sup>

The Aequitas Hybrid fee model will *not* be a maker-taker fee model.

### III. Aequitas Lit

The Aequitas Lit book is a more traditional lit book without any participant restrictions. It will offer the dominant maker-taker pricing mechanism employed by many lit marketplaces.

The proposed matching priority is as follows:

1. Price
2. Broker
3. Non-SME
4. Time

While Aequitas is of the opinion that the maker-taker fee model has generally been detrimental to market quality, we intend to offer such a book in order to compete with the current dominant book models offered in the marketplace. It is our intent to benchmark our lit “take” fees generally to the “take” fees in the Canadian marketplace.<sup>10</sup> Our commitment is to lower our fees in tandem with any reduction in “take” fees in Canada.

Aequitas intends to offer priority to resting non-SME orders both within individual broker priority and in general in its order book. The intent here is to ensure that orders from natural investors enjoy high priority in obtaining fills for resting orders, and to restrict predatory liquidity provision strategies. Other than the above, resting time priority will be featured in this order book.

<sup>8</sup> We discuss the rationale for this priority functionality further in Section 2(c).

<sup>9</sup> Aequitas has filed a patent for its Weighted Size / Time matching prioritization model.

<sup>10</sup> Currently TSX charges 35 mills to take for high priced securities.



Perhaps the most important function of Aequitas Lit will be to serve as the venue for market makers to meet the liquidity display obligations associated with their role. We discuss the general philosophy and rationale of our market maker program in the following section.

### **c) Sustainable Market Making**

Aequitas intends to offer a market making program for both Aequitas listed securities and securities listed on other exchanges. There will be performance obligations (spread, depth and presence) for securities of responsibility. Responsibilities would be met via the Aequitas Lit book.

Aequitas would require market makers to be IIROC members who are members of the Aequitas Exchange. We also propose allowing Direct Execution Access (“DEA”) clients to act as market makers provided their Sponsoring Dealer agrees to be accountable for their actions. We believe this will foster liquidity in a greater number of listings and encourage non-Canadian domiciled HFTs to participate as true market makers and add value to our market.

For securities of responsibility, priority in the Aequitas Dark and Hybrid books would be the primary incentive offered to market makers. Aequitas believes granting priority in these books will be a valued functional benefit for market makers; and, importantly, one that does not rely on a financial subsidy based on the maker-taker fee model.

Importantly, as our SOR will be geared towards combating “book fade”, it will be the philosophy of Aequitas to establish market making obligations that are realistic and consistent with achieving larger average trade sizes. This is important, as our SOR will constantly strive to hold our market makers to the quotes that they display.

### **d) Best in Class SOR Services to Empower Investors**

With parties looking to capitalize on the systemic weaknesses in today’s market ecosystem, it is our view that investors and market quality have suffered. Accordingly, investors and dealers require new tools to help them cope with these realities.

Aequitas intends to offer a best in class SOR service<sup>11</sup> designed to help participants access liquidity across various trading venues while avoiding the orderbook fade so common in today’s markets. The Aequitas SOR offering will place a powerful tool within reach of all investors and dealers.

### **e) Addressing the Cost Issues**

Notwithstanding our concerns about the impact of maker-taker pricing in today’s equity markets, Aequitas recognizes the current dominance of this model. As such, we have

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<sup>11</sup> The model underlying the Aequitas SOR is patented.

concentrated our efforts on devising a unified eco-system that emphasizes investor-focused functionality, sustainable market making and cost efficiency.

While pricing for the Aequitas Dark and Hybrid books has yet to be finalized, our general intent is to offer a low “take-take” fee model across both of these books. Further, in order to foster critically important retail order flow, Aequitas intends to offer discounts on active fees for retail trading networks. This pricing approach will provide substantial savings for both retail and traditional institutional investors.

The Aequitas Lit book, in recognition of the clear role maker-taker continues to play in our marketplace, will offer fees commensurate with those of Canada’s other make-take marketplaces. That said, Aequitas believes that its suite of offerings and eco-system will apply material competitive pressure on the make-take model in general which it believes will moderate industry dependence on this pricing scheme over time.

Aequitas will also propose a highly competitive fee model for its listings offering as well as a new market data offering<sup>12</sup> that it anticipates will provide enhanced value in comparison to any current single marketplace’s data offering at considerable cost savings.

#### **f) A Capital Formation Process in Tune with Issuers and Investors**

Early and mid-stage companies seeking capital find it increasingly difficult to obtain funding from the traditional sources of capital raising: venture capital and the public markets. Part of this difficulty stems from the fact that the cost and overall burden of becoming a public company became very high. Furthermore going to the public markets is only a successful strategy for those companies that can demonstrate tangible progress and growth to support liquidity.

To facilitate these companies’ access to capital, Aequitas will introduce a centralized marketplace for exempt securities (“ESM”)<sup>13</sup> focused on early and mid-stage companies. The ESM will not only allow these companies to raise capital from accredited investors and other permitted participants, but it will also allow them to benefit from secondary trading to provide their investors with liquidity. The ESM will also represent a new business opportunity for the dealer community in the Canadian market, as access will take place through registered dealers.

<sup>12</sup> Aequitas has filed a patent for its new market data offering.

<sup>13</sup> Aequitas has filed a patent for its ESM marketplace.

### 3. Canadian Marketplaces, the Need for Improvement

#### a) Investors and Market Makers, in search of a balanced Playing Field

The current dominant market structure model for Canada’s marketplaces attracts and prefers HFTs over traditional investors and true market makers. This evolution, which is not limited to Canada but is global in nature, occurred based upon the prevailing view that these traditional players are captive clientele of the marketplaces.<sup>14</sup>

Some justify the presence of HFTs as necessary to foster liquidity and downplay any advantage bestowed on HFTs, arguing that preferential access is equally available to all and that fees are unbiased and transparent.

While these arguments are technically true they overlook some important realities:

- The tools offered by marketplaces are uniquely useful to avoid “investing” – rather they are routinely leveraged to sidestep the accumulation of any meaningful position;
- The same tools can also be used to read and anticipate investor demand in the marketplace in real time – allowing low risk profiteering from very short-term moves – again, at the cost of natural investors;
- By nature investors are liquidity takers; therefore held hostage to seek out liquidity across multiple and constantly changing market eco-systems - in this environment the slightest mis-step causes lost liquidity and higher costs to investors; and
- The cost to maintain these eco-systems falls squarely on investors and the networks that support them – coming in the form of fees to take liquidity, high and biased fee structures for market data and generally being forced into a technology spending arms race with no choice and questionable benefits.

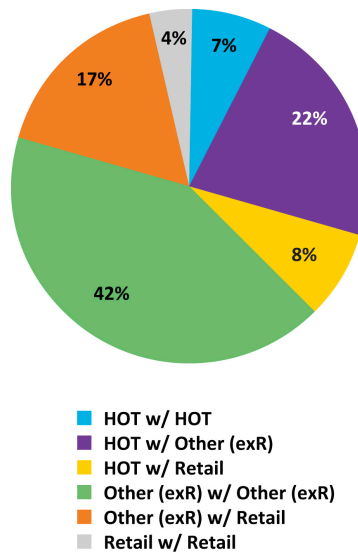
In general, the above evolution has favored opportunistic and predatory profiting by non-investor intermediaries, while traditional investors increasingly see the markets as stacked against them and formal market making becomes unsustainable.

Not surprisingly, investors are accounting for less trading volumes and formal market makers are dwindling. Diagram 2 shows IIROC's HOT Study results for volume breakdown for the data it reviewed as part of its study.

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<sup>14</sup> In Aequitas’ opinion, the Order Protection Rule and similar regulations in other countries have enabled the expansion of HFT activity and, as an unintended consequence, of predatory and opportunistic trading strategies.

Diagram 2: Volume Breakdown in Canadian markets (IIROC HOT Study 2012)<sup>15</sup>

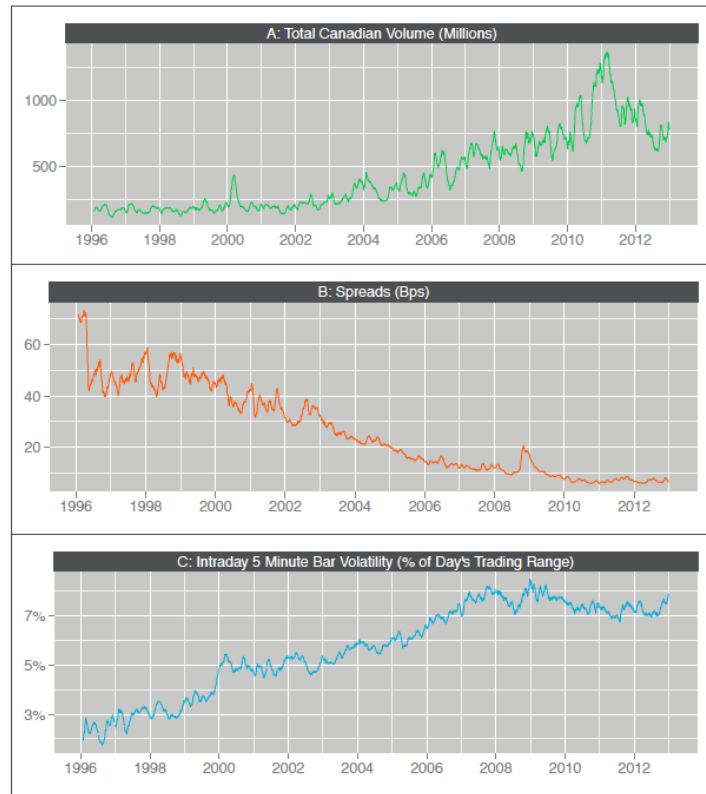


As a result, market quality is challenged:

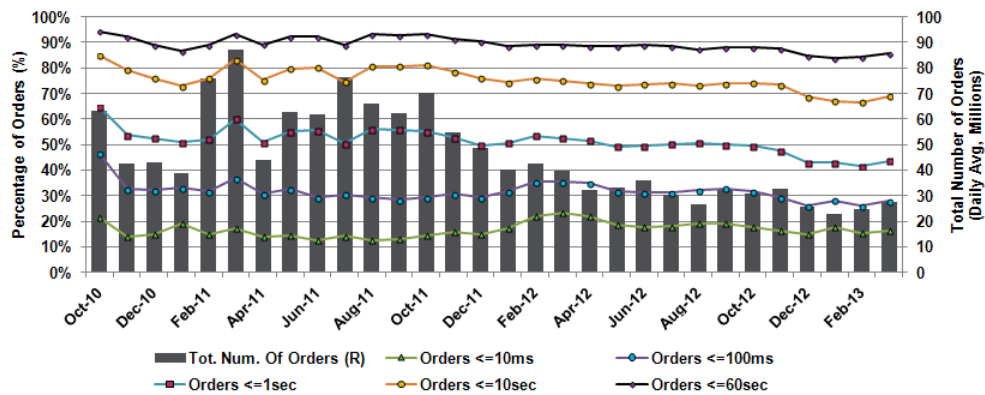
- Displayed spreads are no longer the spreads at which most market participants trade. While displayed spreads have narrowed, the effective spreads at which traditional investors trade have been increasingly subjected to volatile intraday price moves (see Diagram 3 - Part C);
- The displayed picture of liquidity supply is no longer reliable for traditional investors looking to transact in sizes beyond a single board lot (see Diagram 4);
- Overwhelming amounts of market data of declining marginal value has led to a lack of confidence in displayed quotes and increased costs for participants to process it – in particular, for those maintaining networks supporting long-term investors;
- Small and mid-cap securities are in a downward liquidity spiral as designated market makers have been crowded out of the markets.

<sup>15</sup> IIROC HOT Study 2012: [http://www.iiroc.ca/Documents/2012/2fb137e3-4371-43bd-b567-59b789a1e4d7\\_en.pdf](http://www.iiroc.ca/Documents/2012/2fb137e3-4371-43bd-b567-59b789a1e4d7_en.pdf)

**Diagram 3: Volumes, Spreads and Intraday Volatility in Canadian Markets**  
*(Evolution of Canadian Equity Markets, RBC, February 2013)*



**Diagram 4: Percentage of Fleeting Orders in Canadian lit Markets**  
*(Canadian Order Flow Trends, ITG, April 2013)*



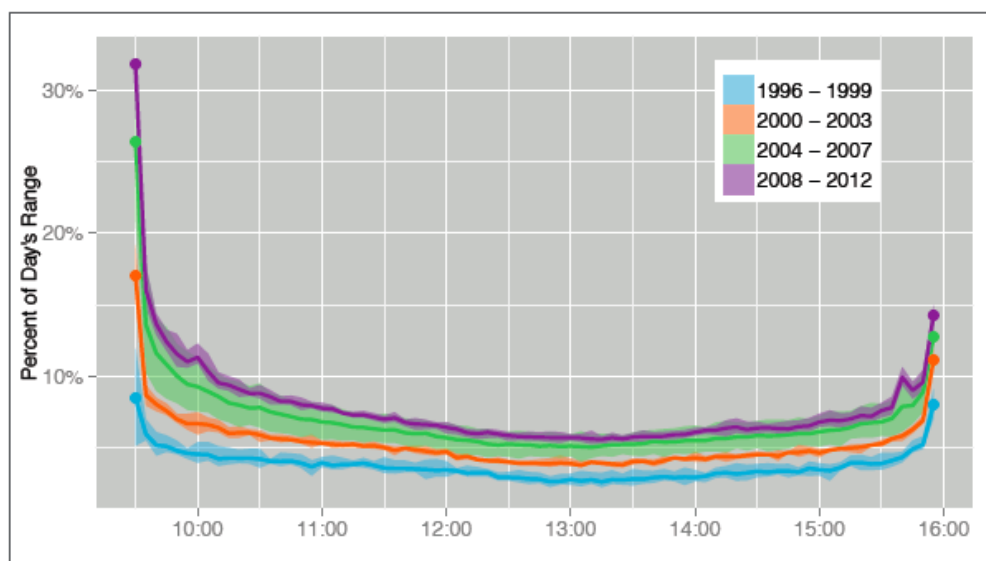
It has been noted by many pundits that intraday trading activity has made trading more challenging for institutional investors.

Turbeville states:

*“Bid/Ask spreads may not widen with HFT activity, but price levels are altered to the detriment of large institutional investors that transact large positions. HFTs eliminate all meaningful depth of interest for a short period of time”.*<sup>16</sup>

Aequitas believes that today’s market structure also has an equally important impact on retail investors – something we highlight in Diagram 5.

**Diagram 5: Shift in Intraday Trading Ranges**  
(RBC Market Structure Conference, April 2013)



The diagram above shows a clear and permanent shift in short-term price volatility that has been most dramatic during the early morning session, thereby suggesting a demonstrable impact to retail trading activity, which tends to trade particularly heavily during this time period<sup>17</sup>.

Similar developments have been observed in other markets such as the U.S. and Europe, and are emerging across other regions in the world.

Curbing these trends is the responsibility of all market stakeholders, and Aequitas believes that sustainable solutions will only result from differentiated competitive marketplace offerings<sup>18</sup>.

<sup>16</sup> Wallace C. Turbeville, “Cracks in the Pipeline Part Two: High Frequency Trading” (March 8, 2013)

<sup>17</sup> RBC estimates that about 60% of its retail order flow trades most days prior to 11 AM.

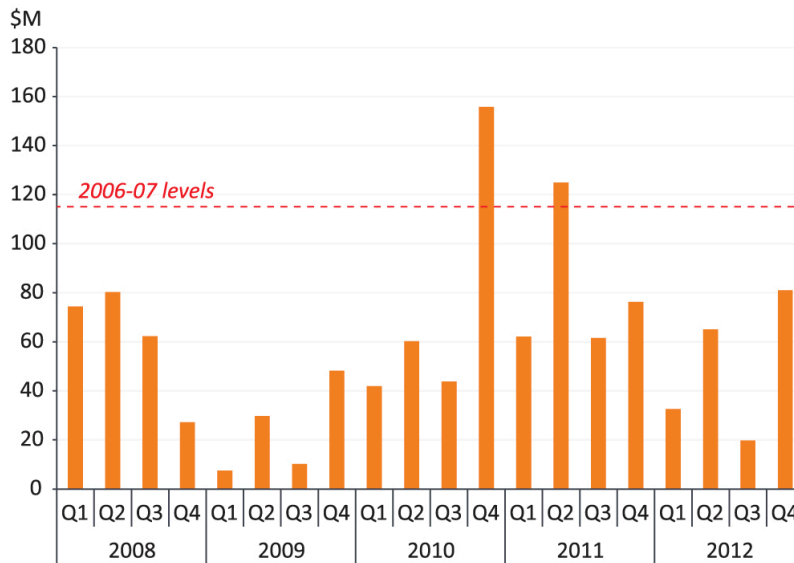
<sup>18</sup> We should not and can not expect all market structure issues to be addressed only by the regulators. Differentiated commercial solutions, with close oversight by the regulators, are needed to be able to address different interests and a continuously evolving environment.

## b) Public Listings, on the Decline

The investor confidence problem is a frequently discussed topic largely recognized by Capital Markets' stakeholders globally. We are however also facing an IPO challenge.

As demonstrated in Diagram 6, less and less companies are interested in going public.

**Diagram 6: Going Public – Launch of Small IPOs**  
*(Letter from the President, vol. 58, IIAC, February 2013)*



There are several reasons for this:

- Many publically listed securities show limited accessible liquidity, impacting their cost of capital for any future rounds of financing;
- The path of public listing is promoted to corporations that are not prepared: not prepared for the regulatory, managerial and financial burden that comes with a public listing, not prepared to attract investor interest to fuel their liquidity and not prepared to understand the responsibilities of going public;
- True market makers, committed to liquidity obligations and critical to new listings, are dwindling and therefore there is less and less liquidity support available for newly listed companies; and
- Initiatives to tackle the harm that is caused to issuers by exacerbated intra-day price volatility, liquidity erosion or hampered buy-back operations, are scarce.

For publically listed companies, Aequitas believes it is critical to re-establish a partnership between the exchange, the issuer and true market makers. For corporations that are not

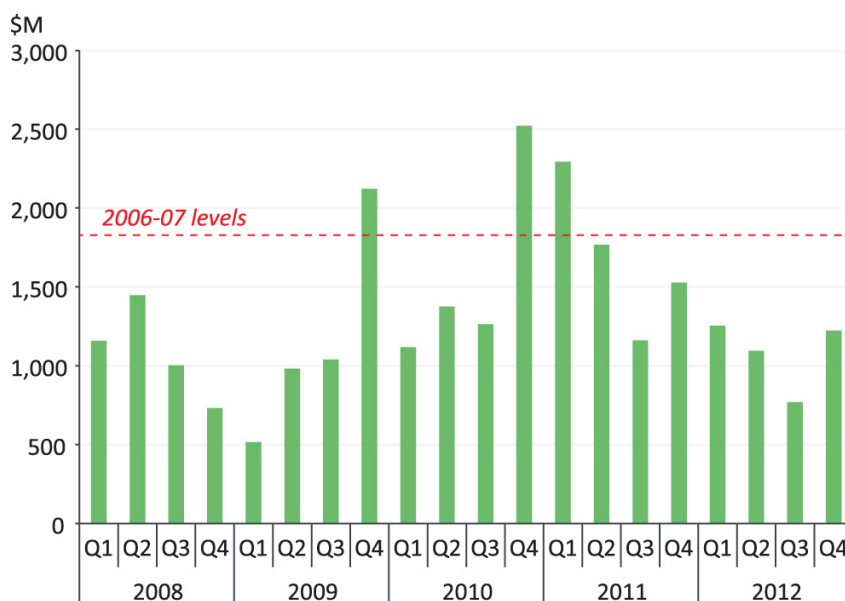
ready for a public listing, but need access to capital and liquidity, Aequitas believes there is a need to provide different innovative alternatives.

### c) Capital Formation for Small and Mid-Size Corporations, a Struggle

Small- and mid-size high-growth corporations are the foundation for future economic growth and employment.

In Canada these corporations are finding it increasingly difficult to access the financing they require to fuel this growth (see Diagram 7). IPOs are often no longer an effective solution and many rapidly fall back on M&A exits or foreign solutions that thwart their Canadian ambitions and potential.

**Diagram 7: Limited Access to Markets – Small Equity Financing**  
*(Letter from the President, vol. 58, IIAC, February 2013)*



Aequitas does not believe that the problem is a lack of potential capital providers or the lack of promising issuers. The challenge is to allow smaller issuers to interact with risk tolerant investors in a way that supports, with the right scale and timeliness, liquidity. Aequitas believes that local angel investor networks have shown us how this can work. We intend to learn from them and amplify their model on a nationwide level.

### d) Dealers, a sustainability Challenge

The success of the primary stakeholders of a marketplace, issuers and investors, also largely depends on the quality of service they obtain from dealers.

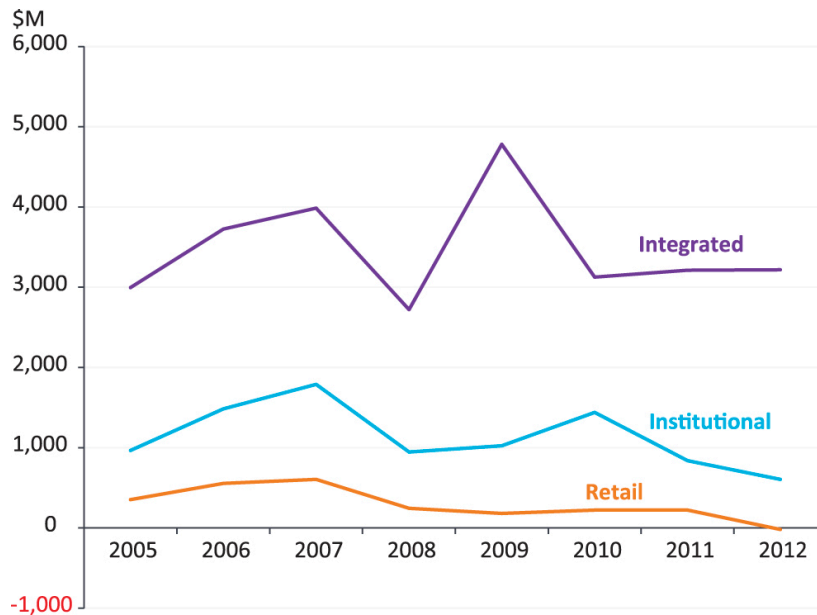


The quality of dealer service is the result of choice, competition and innovation, just as it is with marketplaces. Here another issue emerges: the Canadian dealer community, and in particular the small boutique firms, are under threat.

Diagram 8 shows the evolution of operating profit amongst different categories of dealers.

**Diagram 8: Operating Profit – Integrated vs. Institutional and retail Boutiques**

*(Letter from the President, vol. 59, IIAC, March 2013)*



At the end of last year, close to 50% of the Canadian boutique dealers were losing money and we expect to see an increasing number of casualties resulting from this troubling trend.

This is a consequence of declining volumes and increasing operating expenditure. While the latter is a consequence of multiple factors, Aequitas believes that the dominant market structure model, which taxes the small dealers in various ways, is an important part of the issue. The lack of responsiveness of marketplaces to alleviate the dealers’ cost burdens by promoting new market structure models and reasonable market data pricing needs to be addressed.

## 4. Next Steps

The next steps for Aequitas can be summarized in one word – Dialogue:

- Dialogue with investors and issuers to obtain further insights and ensure that our solutions truly address their issues and challenges;
- Dialogue with dealers, in particular the smaller and mid-size firms, to ensure that our solutions will provide them with the relief they need;
- Dialogue with regulators to explain our solutions and the benefit of enabling commercial solutions that will ensure more balanced and efficient Canadian Capital Markets that ultimately will lead to a stronger economy.

Aequitas' proposal to operate an exchange is subject to regulatory review and, in that same spirit of dialogue, we have commenced discussions with applicable regulators in advance of the filing of a formal application for recognition as an exchange. Aequitas plans to file the formal application towards the end of 2013.

This paper is not a substitute for the regulatory process through which the formal application, which will include specific details of the proposal, would be filed by Aequitas and published for comment. Aequitas will be providing additional detail regarding its proposal as part of that process.

***Our mandate is to improve market quality, promote fairness and foster economic growth with all stakeholders in mind. To allow us to successfully execute this plan, stakeholder input is critical. We look forward to your input.***

***We are at a crossroads for our markets: Make your voice heard.***