

13.2.3 Liquidnet Canada – Notice of Proposed Changes and Request for Comment

LIQUIDNET CANADA

NOTICE OF PROPOSED CHANGES AND REQUEST FOR COMMENT

Liquidnet Canada is publishing this Notice of Proposed Changes in accordance with the “Process for the Review and Approval of the Information Contained in Form 21-101F2 and the Exhibits Thereto.” Market participants are invited to provide the Commission with comment on the proposed changes.

Comment on the proposed changes should be in writing and submitted by May 8, 2017 to

Market Regulation Branch
Ontario Securities Commission
22nd Floor
20 Queen Street West
Toronto, ON M5H 3S8
Fax: (416) 595-8940
marketregulation@osc.gov.on.ca

and

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Comments received will be made public on the OSC website. Upon completion of the Review by OSC staff, and in the absence of any regulatory concerns, notice will be published to confirm the completion of Commission staff’s review and to outline the intended implementation date of the changes.

Any questions regarding the information below should be addressed to:

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Liquidnet Canada proposes to introduce the following changes to the Liquidnet Canada trading system:

1. Increased minimum order size for broker block orders and additional order flow from broker participants

A. Description of the proposed change

Currently, the Liquidnet Canada ATS has two types of broker participants: Liquidity partners (LPs) and Canada broker blocks participants. LPs can send immediate-or-cancel (IOC) orders for Canadian equities, and Canada broker blocks participants can send resting orders for Canadian equities. Currently, the minimum order size for resting orders from Canada broker blocks participants is 50 standard trading units, i.e., 5,000 shares for equities trading over \$1.00. Currently, both LPs and Canada broker blocks participants can send agency orders, but not other types of order flow, such as principal orders, to the Liquidnet Canada ATS.

In an effort to source additional liquidity for buy-side participants, provide sell-side brokers with additional access to unique block-sized liquidity, and align with current practice in the US and European markets, Liquidnet Canada proposes to allow both categories of broker participants, i.e., LPs and Canada broker blocks participants, to send all types of order flow to the Liquidnet Canada ATS, not just agency order flow. To ensure that meaningful block-size orders are submitted, and address concerns regarding possible information leakage, Liquidnet Canada also proposes to increase the minimum order size for Canada broker block orders (whether agency, principal or otherwise) to at least 10,000 shares or \$100,000 in value.¹ Buy-side participants of the Liquidnet Canada ATS will continue to choose whether or not to interact with order flow from Canada broker blocks participants and LPs via Liquidnet's Transparency Controls tool.

B. The expected date of implementation

It is expected that the proposed change will be implemented shortly after satisfaction of the requirements set forth in Section 3.2(1) of National Instrument 21-101, *Marketplace Operation* (NI 21-101), including the expiration of a 45-day notice period. Subscribers will be notified prior to implementation.

C. Rationale for the proposed change

Liquidnet Canada plans to implement this proposed change to expand access to the Liquidnet Canada ATS to broker participants who have requested the ability to participate via additional order types, including principal/liability orders. The proposed change will also permit Liquidnet to source additional liquidity for buy-side subscribers, and align with current practice in the US and European markets. The increase in minimum order size for broker blocks orders will allow for efficient block-volume discovery, limit information leakage, and reduce market volatility as orders are completed in block size. This rationale is consistent with Liquidnet Canada's position as the unique, block-trading marketplace in Canada, with an average negotiated execution size of more than 65,000 shares in 2016.

D. Expected impact of the proposed change on market structure, subscribers, investors and capital markets

We foresee no adverse impact on market structure, subscribers, investors or the capital markets because the proposed change will only encourage broker participants to transmit additional actionable, block-size liquidity to the Liquidnet Canada ATS.

E. Expected impact of the proposed change on Liquidnet Canada's compliance with Ontario securities law and the requirements for fair access and maintenance of a fair and orderly market

We foresee no adverse impact on Liquidnet Canada's compliance with market structure, Ontario securities laws or to requirements of fair access and the maintenance of a fair and orderly market. Liquidnet Canada respectfully submits that increasing the minimum order size for broker block orders to 10,000 shares or \$100,000 in value is consistent with the fair access requirements of National Instrument 21-101 because it will apply to all broker blocks orders and will present no unreasonable barriers to participation. 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." Moreover, 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

¹ These proposed minimums would not apply to IOC orders from LPs.

proposed minimum size for broker block orders is intended to ensure that meaningful block-size orders are submitted, allow for efficient block-volume discovery, limit information leakage, and reduce market volatility. In this context, the proposed minimum block order size does not permit unreasonable discrimination among participants or impose any unreasonable or inappropriate burdens on competition.

F. Consultations undertaken in formulating the proposed change, including internal governance process followed

Liquidnet Canada consulted with certain customers before proceeding with the proposed change. Liquidnet Canada also consulted with Liquidnet affiliates in other regions to understand their models, rationale and experience. The proposed change was approved by the management of Liquidnet Canada.

G. Whether the proposed change will require subscribers and vendors to modify their own systems

The proposed change will not require any work by existing subscribers to modify their own systems because there is no change to existing order execution functionality. Some standard technical work may be required by broker participants who wish to implement this optional service. The proposed change is not a material change to technology requirements regarding interfacing with or accessing the marketplace within the meaning of Part 12.3 of NI 21-101.

H. Whether the proposed change would introduce a fee model or feature that currently exists in other markets or jurisdictions

Liquidnet Canada's US and European affiliates already permit principal order flow from broker participants.

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2. Expansion of conditional order functionality for Canadian equities

A. Description of the proposed change

Currently, Member participants of the Liquidnet Canada ATS can create LN auto-ex orders, which can access the Liquidnet negotiation and H2O (auto-execution) systems, but not external venues, on a conditional or firm basis, as directed by the Member. Prior to executing a conditional LN auto-ex order, Liquidnet sends a request to the Member's system to commit the shares on the order, and the Member's system responds by sending all or a portion of its remaining unexecuted shares to Liquidnet (known as a "firm-up"). This firm-up request is used to protect the Member against over-execution. Member firm-up rates are periodically reviewed by Liquidnet Sales personnel, with appropriate follow-up to the Member to address any issues.

As also previously disclosed, conditional order functionality is currently incorporated into Liquidnet Canada's algo order functionality such that, for certain types of algos, Liquidnet interacts with the negotiation and H2O (auto-execution) systems on a conditional basis. This type of conditional functionality does not require a firm-up request from the Member or customer. Instead, the Liquidnet algo, which could be working shares at an external venue, must firm-up the order to the negotiation and H2O system, as applicable, immediately prior to execution.

In an effort to align with the US market and provide additional trading flexibility to participants of the Liquidnet Canada ATS, Liquidnet Canada proposes to further expand conditional order functionality to the interaction of resting orders from Canada Broker Block participants with the Liquidnet negotiation system.

Conditional orders from Canada broker blocks participants

"Canada broker blocks participants" are IROC-registered Canadian brokers that can enter committed orders on behalf of their customers (currently, agency orders only),² via FIX, using compliant order-entry technology. These brokers are considered direct participants in the Liquidnet Canada ATS, and their orders are referred to as "Canada broker block orders". These brokers do not have access to the Liquidnet desktop application. In handling a Canada broker block order, Liquidnet Canada creates a Liquidnet algo order. These resting orders interact with Liquidnet liquidity in the same manner as orders from trading desk customers, but trading desk personnel do not have access to order information of Canada broker blocks participants. Members and eligible customers elect through Liquidnet Transparency Controls whether or not to interact with order flow from Canada broker blocks participants.

² As indicated in Part 1 of this Notice, Liquidnet Canada is also proposing that broker participants, i.e., liquidity partners (LPs) and Canada broker blocks participants, also be permitted to transmit non-agency order flow, such as principal orders.

Liquidnet Canada proposes to permit Canada broker blocks participants to transmit resting orders to the Liquidnet Canada ATS on a conditional basis, at their option. This functionality, which is fully automated from the point at which the broker transmits the conditional order to Liquidnet, allows the broker to rest actionable order flow in the Liquidnet Canada ATS that may include shares already placed at other trading venues. These orders are considered “conditional” since the Canada broker block participant will commit the order only prior to execution with a matched contra order. Prior to executing a conditional order, Liquidnet sends a request to the Canada broker block participant’s system to commit the shares on the order, and the broker’s system responds by sending remaining unexecuted shares to Liquidnet (known as a “firm-up”). This firm-up request is used to protect the Canada broker block participant against over-execution. Broker firm-up rates are periodically reviewed by Liquidnet Sales, with appropriate follow-up to the broker to address any issues.

B. The expected date of implementation

It is expected that the proposed change will be implemented shortly after satisfaction of the requirements set forth in Section 3.2(1) of National Instrument 21-101, *Marketplace Operation* (NI 21-101), including the expiration of a 45-day notice period. Subscribers will be notified prior to implementation.

C. Rationale for the proposed change

As Liquidnet operates a global trading system, Liquidnet Canada is implementing this proposed change to align with the US region and provide broker participants with functionality currently available to other participants. This functionality will allow broker participants to seek block-sized liquidity in the Liquidnet Canada ATS and other dark/lit venues simultaneously, without risk of over-execution. Brokers will also benefit from reduced information leakage and associated predatory trading behavior on large size orders. This change will also benefit the marketplace as a whole by not forcing participants to choose one market over another, thereby exposing liquidity more broadly across multiple marketplaces.³

D. Expected impact of the proposed change on market structure, subscribers, investors and capital markets

We foresee no adverse impact on market structure, subscribers, investors or the capital markets because the proposed change will only encourage broker participants to rest liquidity at the marketplace, without limiting trading opportunities at other venues.

E. Expected impact of the proposed change on Liquidnet Canada’s compliance with Ontario securities law and the requirements for fair access and maintenance of a fair and orderly market

We foresee no adverse impact on Liquidnet Canada’s compliance with market structure, Ontario securities laws or to requirements of fair access and the maintenance of a fair and orderly market.

F. Consultations undertaken in formulating the proposed change, including internal governance process followed

Liquidnet Canada consulted with certain customers before proceeding with the proposed change. The proposed change was approved by the management of Liquidnet Canada.

G. Whether the proposed change will require subscribers and vendors to modify their own systems

The proposed change will not require any work by existing subscribers to modify their own systems because this is optional functionality. Standard technical work will be required by broker participants who wish to implement this optional conditional order functionality.

H. Whether the proposed change would introduce a fee model or feature that currently exists in other markets or jurisdictions

Liquidnet Canada’s US affiliate has already implemented similar functionality for broker participants.

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³ This proposed change also supports the Canadian regulators’ efforts to encourage broker dealers to trade in non-transparent venues as part of fulfilling their best execution obligations. See UMIR Policy 5.1 – Best Execution of Client Orders, Part 2 - Specific Factors To Be Considered, http://www.iiroc.ca/industry/rulebook/Documents/UMIR0501_en.pdf

3. Addition of “automated routing customers” as participants on the Liquidnet Canada ATS

A. Description of the proposed change

The Liquidnet Canada ATS currently permits four (4) categories of participants to trade Canadian equities:

- Members
- Trading desk customers
- Canada broker blocks participants
- Liquidity partners (LPs)

In an effort to align with other regions and provide additional flexibility to buy-side institutions wishing to participate in the Liquidnet Canada ATS, Liquidnet Canada is proposing a fifth participant category – known as “automated routing customers.” As an automated routing customer, a buy-side institution meeting certain applicable admission criteria will be able to transmit orders (including conditional orders) to the Liquidnet Canada ATS via an automated router, subject to applicable risk controls. These buy-side institutions can participate directly, through a service provider, or through a routing securities dealer (referred to as an “automated routing dealer”) as long as the securities dealer identifies the buy-side institution to Liquidnet on an order-by-order basis (through FIX or an equivalent mechanism). Similar to existing trading desk customers, an automated routing customer will not have access to the Liquidnet desktop application.

Admission and retention criteria for automated routing customers

An automated routing customer must be: (A) an institutional investor that transmits orders through an internal order router; (B) an institutional investor that transmits orders through an order router operated by a third-party service provider; or (C) a securities dealer that transmits orders through an order router on behalf of one or more institutional investors. Automated routing customers under (A) and (B) are referred to as buy-side automated routing customers; securities dealers under (C) are referred to as automated routing brokers. In addition to these criteria, buy-side automated routing customers and customers of an automated routing broker also (i) must have total equity assets, or total equity assets under management, of US \$100 million or more, or the equivalent in another currency and (ii) must execute block trades as part of its regular course of trading activity. Buy-side automated routing customers must also enter into a subscriber agreement and other documentation required by Liquidnet.

For an automated routing customer relationship that involves a service provider or securities dealer (a provider), the provider must satisfy Liquidnet Canada, and Liquidnet Canada must determine, that the provider’s order handling processes will not cause frustration to, or adversely impact, other Liquidnet participants. In making this determination, Liquidnet will take into consideration a variety of factors, including the provider’s automated routing logic and venue prioritization, use of conditional orders, use of committed orders, data usage and disclosure, risk controls and compliance oversight.

In the case of a securities dealer transmitting an order on behalf of a buy-side firm, the securities dealer must identify the buy-side firm to Liquidnet on an order-by-order basis (through FIX or an equivalent mechanism).

An automated routing customer must satisfy credit and legal criteria as Liquidnet or its clearing broker may establish from time to time. This includes Liquidnet’s compliance with any customer identification procedure and other anti-money laundering rules and regulations relating to customer due diligence. Liquidnet’s clearing broker must also consent to the entity as a Liquidnet customer.

Guidelines for automated routing customers

Liquidnet plans to implement the following guidelines for automated routing customer orders transmitted through a service provider or broker-dealer (referred to as a “provider”):

- For firm orders, average order resting time of one minute or more
- For conditional orders, average order resting time of two minutes or more.

These guidelines are intended to maximize the value of the interaction between automated routing customers and other Liquidnet participants for the benefit of each side. On a quarterly basis, Liquidnet will review each provider’s performance relative to these guidelines. If a provider fails to meet these guidelines on a consistent basis, Liquidnet

can commence a discussion with the provider as to whether it is beneficial for the provider and Liquidnet's participants to continue the automated routing relationship. Automated routing customers are also subject to the same minimum order size requirements as other buy-side Member participants.

Notification of active contra to automated routing customers

Liquidnet automated routing customers (or their respective service providers) transmitting algo orders (including conditional orders) may receive electronic notification in real-time of the matching of an algo order with an active contra.

Automated market surveillance for conditional orders by automated routing customers

When an automated routing customer that transmits conditional orders fails to firm-up for a configured number of times within a configured time period in a particular symbol, the automated routing customer will be automatically blocked from matching in that symbol with any contra-indications in the negotiation system and/or from matching in that symbol with any contra-side conditional orders in Liquidnet H2O for a configured time period.

In addition, where Liquidnet has blocked an automated routing customer from matching in a configurable number of symbols within a trading day pursuant to the preceding paragraph, Liquidnet will block all orders from that automated routing customer for the remainder of the trading day and cancel all orders received by Liquidnet from that customer that are then outstanding. As noted above, orders from automated routing customers are also subject to the same risk controls applied by Liquidnet Canada to all other algo orders.

Liquidnet also may block conditional orders from an automated routing customer if the automated routing customer's average order duration is below thirty (30) seconds for a configurable period of time.

Liquidnet can set and modify the configurations from time to time, but at any particular time the same configurations apply for all automated routing customers transmitting conditional orders. Upon request, Liquidnet will notify any Member or customer regarding the applicable configurations at that time.

B. The expected date of implementation

It is expected that the proposed change will be implemented shortly after satisfaction of the requirements set forth in Section 3.2(1) of National Instrument 21-101, Marketplace Operation (NI 21-101), including the expiration of a 45-day notice period. Subscribers will be notified prior to implementation.

C. Rationale for the proposed change

As Liquidnet operates a global trading system, Liquidnet Canada is adding this new participant category to align with other regions and provide an additional automated means for Canadian buy-side participants to access the Liquidnet Canada ATS, i.e., via an internal or third-party order router as opposed to the Liquidnet desktop application. Automated routing customers currently participate and provide valuable liquidity in other markets.

D. Expected impact of the proposed change on market structure, subscribers, investors and capital markets

We foresee no adverse impact on market structure, subscribers, investors or the capital markets because the proposed change will only add liquidity from buy-side participants who would otherwise not participate on the marketplace. We also note that the proposed change is an optional means by which buy-side participants may access the Liquidnet Canada ATS. Buy-side participants may still access the Liquidnet Canada ATS as Members via our existing desktop software application.

E. Expected impact of the proposed change on Liquidnet Canada's compliance with Ontario securities law and the requirements for fair access and maintenance of a fair and orderly market

We foresee no adverse impact on Liquidnet Canada's compliance with market structure, Ontario securities laws or to requirements of fair access and the maintenance of a fair and orderly market.

F. Consultations undertaken in formulating the proposed change, including internal governance process followed

Liquidnet Canada consulted with certain customers before proceeding with the proposed change. The proposed change was approved by the management of Liquidnet Canada.

G. Whether the proposed change will require subscribers and vendors to modify their own systems

The proposed change will not require any work by existing subscribers to modify their own systems because this is an optional method for interacting with the Liquidnet Canada ATS, not a requirement. Standard technical work will be required by new subscribers opting to participate as automated routing customers. The proposed change is not a material change to technology requirements regarding interfacing with or accessing the marketplace within the meaning of Part 12.3 of NI 21-101.

H. Whether the proposed change would introduce a fee model or feature that currently exists in other markets or jurisdictions

Liquidnet Canada's affiliates in other jurisdictions have already implemented the proposed automated routing customer participant category.