AEQUITAS NEO EXCHANGE
TRADING POLICIES AMENDMENTS

January 26, 2017

In accordance with Schedule 5 of its recognition order dated November 13, 2014, as amended (the "Protocol"), Aequitas NEO Exchange Inc. ("NEO Exchange") has adopted and the Ontario Securities Commission (the "OSC") has approved amendments to the NEO Exchange trading policies (the "Trading Policies Amendments"). The Trading Policies Amendments are "Public Interest Rules", as defined under the Protocol, and were published for comment on June 2, 2016. NEO Exchange received two comment letters on the Public Interest Rules, the summary of which is attached to this notice as Appendix A.

The Trading Policies Amendments, with the two minor changes described in Appendix B, were approved by the Ontario Securities Commission ("OSC") today. As further described in the summary of comments, the OSC notice can be viewed here. The amendments will become effective on April 20, 2017.

We would like to take this opportunity to suggest that full disclosure be required from the other Canadian recognized exchanges with respect to their market making programs, not only to facilitate a more granular comparison among such programs, but also to ensure that current practices and procedures are well understood and that trading strategies are fully informed.

The revised trading policies are available on the NEO Exchange website.

APPENDIX A

Summary of Comments re: Proposed Auto-Execution Facility-related Amendments to the NEO Exchange ("NEO") Trading Policies

We received two comment letters: one from National Bank Financial Markets (NBF) and the other from the Canadian Security Traders Association's Trading Issues Committee (CSTA).

Summary

The Auto-Execution Facility (AEF) was constructed to further enhance the liquidity provision experience on NEO and compete with facilities that are currently in place on two other exchanges in Canada – the TSX's MGF and the CSE's GMF, with the former having been in existence for well over a decade. While we believe that the AEF will benefit overall liquidity on NEO, we also believe it is important to continue the dialogue with industry stakeholders to evolve it into a facility where all long term investors can partake regardless of the nature of their flow. We are also of the opinion that by introducing this facility on a marketplace that has an array of tools to promote interactions amongst all long term investors and avoid unnecessary intermediation, concerns about additional segmentation are considerably mitigated.

Reviewing a proposed facility like the AEF in the context of the broader markets and the existing regulatory framework is an important element of the regulatory process and we were disappointed that we did not receive more extensive comments, although we acknowledge that industry participants are understandably experiencing comment fatigue and/or facing internal pressures. It is also our view that this proposal and the comments received raise the larger issue of whether we collectively (industry and regulators) are looking at changes to market structure in a holistic way. As analyzed in more detail in our responses below, the more technical comments raised about the distinctions between our proposal and the already operating guaranteed fill mechanisms are more of form than of substance. The more material comments raised, all relating to order flow segmentation concerns, apply not only to the AEF but to the similar facilities referenced above and specific market models like TSX Alpha. We also address these comments in more detail under our responses below.

If, through the review of our AEF, a determination had been made by the regulators that a facility of this nature should not be operating in our markets for segmentation reasons or that it was not consistent with the dark rules, then consistency and fairness would have dictated that all other substantially similar facilities would need to be de-commissioned as well. To allow such an analysis to be done in a transparent way, however, other Canadian exchanges would need to disclose the full details of their market making programs. As we will point out several times below, a number of key features available in these programs are not publicly documented.

Issues raised, comments and responses

<u>Issue 1</u>: Order segmentation in the AEF facility

- NBF does not see the need for retail segmentation in the AEF facility and is generally against order segmentation in Canada. NBF's preference is a marketplace that hosts the most diversity of flow interacting in the simplest possible way.

- NBF acknowledges that although other similar facilities (TSX's MGF, CSE's GMF) segment flow based on the type of order (parent order size & degree of automation), they do not explicitly segment out different counterparties.
- NBF would advocate adoption of the AEF without the explicit Retail segmentation. NBF instead suggests using the NEO Exchange's existing "NEO Trader" classification to identify AEF-eligible orders.
- CSTA states that based on the inverted pricing structure in the NEO Book, retail flow would be incentivized to route to the NEO Book to partake in the AEF guaranteed fills. CSTA likens this "first-look" for DMMs at marketable flow to allowing for Payment for Order Flow ("PFOF" for retail orders).
- CSTA stresses its historical position against various types of order segmentation that are to the detriment of execution quality of institutional investors and the overall integrity of the Canadian markets.
- CSTA adds that the AEF would segment retail flow away from institutional investors and by extension deprive the visible markets of a valuable source of order flow.

<u>NEO Exchange Response</u>

While we understand the concerns raised around order segmentation, the type of segmentation that the AEF enables has been in place on Canadian lit marketplaces for many years with the TSX's MGF facility, and it has recently been reaffirmed with the CSE's GMF facility. The difference between these facilities and a model like TSX Alpha (which enables segmentation differently but in a much more substantial way) is that liquidity provision in these facilities is limited to market makers with liquidity provision obligations to the exchanges. In other words the market makers are or should be providing a service that benefits all market stakeholders within and beyond the frame of the facility. These facilities are part of the benefits and obligations package that marketplaces provide to market makers to support liquidity, and it is within that context that they should be assessed.

Upon consideration of the concerns raised around order segmentation, in particular retail segmentation, we did try to find a way to expand the eligibility criteria for accessing AEF liquidity to include all NEO Trader IDs, including institutional and retail orders of all sizes and with no restrictions. The conclusion was, however, that it would be impossible for a market maker to manage its risk if institutional orders (of all sizes and without restrictions) could interact with the AEF as designed. That said, we do believe that an AEF-type of solution that supports all NEO Trader IDs, without restrictions, would be beneficial to the market and will seek to advance the discussion around such solution in the coming months through additional dialogue with industry stakeholders, to be followed by a separate filing.

With respect to our definition of eligible orders in the AEF, it should be noted that it is virtually identical to that for the MGF and GMF, as all three facilities define an eligible order as one that cannot be part of a larger order, or from a DEA/DMA client (unless it is a registrant trading on behalf of client order flow). The MGF and AEF further expand the criteria and exclude orders generated by computer algorithms. The <u>only element unique to the AEF</u> is that we work on the basis of configuring eligible Trader IDs at a system level, whereas the other solutions require the dealer to identify eligibility on an order by order level.

NEO Exchange already has NEO Trader IDs certified, including a sub-category which is "Retail". This allows us to distinguish retail orders which, by their nature, fit the eligibility criteria listed above. **We stress, however, and the commenters may not have noticed this, that our definition of AEF-eligible orders allows participation by any NEO Trader ID that generates orders that meet the criteria, regardless of whether it is certified as Retail**.

Finally it is also our view, given that the proposed AEF definition and the existing MGF and GMF definitions arrive at virtually the same eligibility standard, that consistency and fairness dictate that either the AEF is acceptable as proposed, or there should be no such form of facility at all and the approvals of the MGF and GMF would have to be reversed. We are favourable to an initiative that would analyze, on a going forward basis, the merits of these facilities in general as well as whether the obligations and benefits are balanced (this would require a higher level of transparency around market marking programs in place at other exchanges).

***Issue 2* - No obligation for DMMs to provide guaranteed fills in the AEF**

- CSTA compares the AEF facility to the GMF and MGF, and stresses that the key difference is that the AEF does not require any fill obligations from their DMMs.
- CSTA argues that this "on/off" option of the AEF is not akin to the TSX Participation feature, as the TSX Participation feature is a benefit that offsets the obligation of the MGF, whereas the AEF is a benefit with no offsetting obligation.
- NBF offered no comments on the lack of a fill obligation in the AEF.

NEO Exchange Response

We disagree that the lack of an obligation for the DMM to provide guaranteed fills in the AEF differentiates it from the MGF and GMF facilities. Ultimately, there is no obligation for a market maker using the MGF or GMF facility to provide any liquidity beyond odd lot executions. By setting the liquidity provision obligations on the MGF or GMF facility to the minimum (199 shares for securities over $1), the result is equivalent to turning the AEF off. In all cases the only obligation that remains for the market maker is to fill odd lot orders.

In addition to the above, the range and extent of obligations that we put on our market makers above and beyond the AEF were not considered in the comments. We believe that, when considering obligations and benefits, the entire market making regime should be considered. Although the metrics relating to market makers' obligations at the other exchanges are not public, we understand that they are less onerous.

The AEF is intended to serve as a value-add facility for those long term investors whose orders are naturally smaller-sized, so that they may source liquidity without being overly-intermediated by parties that are not providing a service to the markets. At the same time, we tried to balance this objective with the need of our DMMs to be in a position where they can reasonably manage their risks. The adoption by investors of increasingly sophisticated automated tools can indeed lead to DMMs being detrimentally "hit" in the AEF multiple times in a short time span. This is similar to what Registered Traders (RTs) on the TSX experienced, which first led to the MGF eligibility criteria. We believe it is more appropriate to let the DMMs manage their own risks by adjusting their size intra-day, rather than rely on the discretion of the exchange and/or have to seek to have their trades cancelled after abuse or non-compliance was identified.

In addition, we believe that our proposed active management of size by the DMMs is key to providing better liquidity and will benefit the retail community as it allows for potentially larger guaranteed fill sizes.

This is why we are retaining, as an element of the AEF, the DMMs' ability and discretion to adjust the minimum fill size intra-day. However, based on concerns raised by OSC Staff, we have agreed to include a maximum size of 50 standard trading units. Although we disagree that an uncapped AEF would be detrimental to the market in any way, we are comfortable that a maximum of 50 standard trading units will not limit the effectiveness of the AEF in the short term.

Finally, we wish to note that the ability to vary the size of the guaranteed fill presently exists on the MGF and GMF facilities (just not through electronic means). Although it is not possible to confirm this via any public information in respect of the MGF facility, for example, it is our understanding that RTs have the ability to have the MGF dropped by calling the TSX including, in some circumstances, to the minimum allowed (199 shares for securities over $1), without notice to the market. In any case, there is no obligation for a market maker to provide more than the minimum (which as discussed above represents odd lot obligations) for any security on any given day. Note that this is based on our consultations with market participants; we could not find any such disclosures in the public documentation available from the other exchanges.

***Issue 3*: Violation of dark rules**

- NBF likens the AEF functionality to a dark order type that would violate the Canadian dark rules.
- CSTA argues that since the AEF additional quantity wouldn't be visible on a consolidated market display (or disseminated through the IP), it would not meet the NI 23-101 definition of "being displayed on a marketplace" and would thus be considered a dark order.
- CSTA states that since AEF orders trade at the NBBO, and are not constrained to active orders that fall under the "large order" definition by the dark rules, they would be in violation of the dark rules as they would not satisfy price improvement requirements of trading in the dark.

NEO Exchange Response

Again, these observations about the AEF apply equally to the existing functionality of the MGF and GMF facilities. If an auto-execution facility is in violation of the dark rules, then all guaranteed fill mechanisms, as well as the TSX RT "participation" functionality, would be in violation as well. All of these can be argued to be offering fills at the NBBO "in the dark", without offering price improvement for orders that would not fit the "large" trade criteria in the dark rules.

Similar to the point made in our response to the first set of comments, we stress that any issue with the AEF in relation to fills by market makers and compliance with the dark rules should be considered consistently across all similar mechanisms. While this issue may not have been considered when the other mechanisms were approved, consistency and fairness dictate that all mechanisms be treated equally.

Conclusion

In summary, we plan to move forward with the AEF, with the following distinctions from the other facilities, based on the discussion and analysis above:

- The incoming order size is not restricted to the AEF size. Any sized order will interact with the AEF after any midpoint orders and regular orders at the NBBO have been cleared first.
- DMMs can adjust the AEF size electronically throughout the day up to a maximum of 50 standard trading units.

We believe that facilities of this nature all serve as a net benefit to the market makers, but agree with the CSTA that they are of the greatest benefit if they are restricted to retail-only contra orders. This, however, was not the purpose behind the AEF design, and we remain committed to finding a balanced solution that would allow DMMs to provide liquidity to all NEO Trader IDs, including institutional and retail orders of all sizes and with no restrictions on the means for generating them. We also believe that the appropriate approach to analyzing the merits of this type of facility goes beyond weighing the market makers' obligations versus their benefits in such a facility in isolation, but instead requires an analysis of the market making program available at each marketplace as a whole.

It is apparent that the mechanisms underpinning these types of facilities are intertwined with the broader market maker programs in place. The comparison of the three exchanges' market making programs, as far as we have been able to ascertain regarding the other programs, is set out in Schedule A. It shows that all three exchanges provide different benefits to balance market makers' obligations. It also highlights that some of the elements that were identified as being different with respect to the AEF are either not different at all or are based on a misunderstanding of the other exchanges' functionality.

Schedule A to Appendix A
Comparison of Market Making Programs (NEO Exchange / TSX / CSE)

		NEO Exchange[1]	TSX[2]	CSE[3]
OBLIGATIONS	SIZE REQUIREMENTS (TWO-SIDED)	YES -Size requirements public (on website)	UNKNOWN -requirements not public	UNKNOWN -requirements not public
	SPREAD REQUIREMENTS (TWO-SIDED)	YES -Spread requirements public (on website)	UNKNOWN -requirements not public	UNKNOWN -requirements not public
	ODD-LOT EXECUTIONS	YES -Auto-executions @ NBBO	YES -Auto-executions @ NBBO	YES -Auto-executions @ NBBO
	GUARANTEED FILL FACILITY	AEF -Open to retail and small-sized institutional orders only -Option to adjust amount per side up to a maximum	MGF -Open to retail and small-sized institutional orders only -Reduce/increase amount by request to exchange -Unsuitable trades may be cancelled upon market makers' request	GMF -Open to retail and small-sized institutional orders only -Reduce/increase amount by request to exchange -Unsuitable trades may be cancelled upon market makers' request
BENEFITS	TRADING FEE BREAKS	N/A	YES -Odd-lots free only for MMs -Opening, notes, debentures free -Non-ETF MM: first $20,000 of net monthly trading fee in assignments waived	YES -Odd-lots free only for MMs -Reduced fee for TSX-listed 'Designated Securities' -Free active/passive for TSX-listed <$1/ CSE-listed/ TSXV-listed
	QUEUE PRIORITY	YES -MMVA (up to 15% of daily traded volume in symbol) only when at top of book with visible order and meeting all obligations	YES -RT Participation (up to 40% of any order MGF-sized or less) without the need to be top of book	YES (proposed) -MM Participation (up to 40% of any GMF-eligible order) without the need to be top of book
	OTHER	YES -Monthly bonus pool if eligibility criteria (based on meeting obligations) met -Issuer Performance Program for NEO-Listed securities (issuer's option)	YES -Tier B symbol credit ($100) for MMs that meet their monthly performance scores -Symbol credit of $20 per symbol	N/A
PERFORMANCE	PERFORMANCE METRICS AND/OR REPORTING	YES - PUBLIC -Review of obligations, size, and spread -Performance reports available on website	YES - PRIVATE -Review of obligations and improved liquidity -No performance reports available	YES - PRIVATE -Spread, presence, volatility -No performance reports available

[1] https://aequitasneoexchange.com/en/trading/designated-market-makers
[2] https://www.tsx.com/trading/toronto-stock-exchange/order-types-and-features/market-maker-system
[3] http://thecse.com/en/services/become-market-maker

APPENDIX B

TEXT OF CHANGES TO PUBLISHED PUBLIC INTEREST AMENDMENTS TO THE TRADING POLICIES

"**AEF Eligible Trader ID**" means a Trader ID certified by the Member as being used only for either:

(1) orders from one or more NEO Trader Retail Customer accounts; or

(2) any NEO Trader client orders, each of which is not:

(a) part of a larger order (whether or not the entire order is entered on the NEO Book™ or split among multiple marketplaces),

(b) generated by a computer algorithm, or

(c) from a DEA Client, unless it is a US registrant trading only on behalf of clients.

...

8.07 Auto-Execution Facility (AEF)

~~(1) A Designated Market Maker may set the following for each AEF Eligible Security:~~

~~(a) a guaranteed fill size, to make the security available for AEF; and~~

~~(b) AEF participation on the buy side only, sell side only, or both buy and sell side.~~

~~(2)~~(1)Only IOC market or limit AEF Eligible Orders will be accepted.

~~(3)~~(2) AEF Eligible Orders sent to the NEO Book™ for an AEF Eligible Security will be auto-executed by a DMM at the available NBB or NBO price up to the guaranteed fill size only after any visible or non-visible iceberg order volume at the NBB or NBO in the NEO Book™ has traded. Any remaining volume, after the AEF Eligible Order has traded against the volume at the NBB or NBO and received auto-execution, will trade in accordance with Section 8.04.

~~(4)~~(3) Not all securities will be AEF Eligible Securities.