

NOTICE OF PROPOSED NATIONAL INSTRUMENTS AND COMPANION POLICIES  
UNDER THE SECURITIES ACT

NOTICE OF PROPOSED NATIONAL INSTRUMENT 21-101  
*MARKETPLACE OPERATION*, COMPANION POLICY 21-101CP AND  
FORMS 21-101F1, 21-101F2, 21-101F3 AND 21-101F4

AND

NOTICE OF PROPOSED NATIONAL INSTRUMENT 23-101  
*TRADING RULES* AND COMPANION POLICY 23-101CP

AND

DISCUSSION PAPER ENTITLED "CONSOLIDATION PLAN FOR A  
CONSOLIDATED CANADIAN MARKET"

## **Introduction**

The Commission, together with the other members of the Canadian Securities Administrators ("CSA") staff, are publishing for comment proposed National Instrument 21-101 *Marketplace Operation* ("NI 21-101"), Companion Policy 21-101CP ("Companion Policy 21-101CP"), Forms 21-101F1, 21-101F2, 21-101F3 and 21-101F4 (the "Forms"), proposed National Instrument 23-101 *Trading Rules* ("NI 23-101"), Companion Policy 23-101CP ("Companion Policy 23-101CP") and a Discussion paper on a Plan for a Consolidated Canadian Market ("The Consolidation Plan"). The CSA are also publishing a Background Paper, attached hereto as Appendix "A", entitled "Regulation of Alternative Trading Systems in Canada" presenting the history and debate on the issues concerning the operation of alternative trading systems ("ATSS") in Canada.

The documents currently being published for comment have been prepared by a working committee of CSA staff. The documents have been formally approved by some, but not all, commissions. In light of the desire to publish the ATS proposal, the documents are being published now for public comment. It is expected that formal approval by all commissions will be forthcoming.

The proposed National Instruments, Forms and Companion Policies are initiatives of the CSA. The proposed National Instruments are proposed to be adopted as rules in each of British Columbia, Alberta, Manitoba, Nova Scotia and Ontario, as a Commission regulation in Saskatchewan and as a policy in each of the other jurisdictions represented by the CSA. The proposed Companion Policies are proposed to be adopted as policies in each of the jurisdictions represented by the CSA.

Terms used in the proposed Companion Policies that are defined or interpreted in the proposed National Instruments or a definition instrument in force in the jurisdiction and not otherwise defined in the proposed Companion Policies should be read in accordance with the proposed National Instruments or that definition instrument, unless the context otherwise requires. The National Instruments, Forms and Companion Policies contain footnotes that are not part of the proposed National Instruments, Forms or Companion Policies, which have been included to provide background and explanation.

## **A. NATIONAL INSTRUMENT 21-101 *MARKETPLACE OPERATION***

### ***Scope of the Instrument, Policy and Forms***

NI 21-101 and the Companion Policy 21-101 CP regulate all marketplaces operating within the jurisdictions of the CSA. Marketplaces include recognized stock exchanges, recognized quotation and trade reporting systems as well as ATSS. A marketplace participant is defined to mean a member of an exchange, a user of a quotation and trade reporting system or a subscriber of an ATS. NI 21-101 and Companion Policy 21-101CP provide guidelines for establishing which types of marketplaces are considered to be exchanges and must be recognized as exchanges and which types of marketplaces may be considered as ATSS.

NI 21-101 sets forth a number of requirements for exchanges and quotation and trade reporting systems, such as reporting and record keeping. These requirements exist currently in some jurisdictions. NI 21-101 further specifies several new requirements including access and systems capacity requirements that reflect the increased importance of technology for these markets, and transparency and market integration requirements. The Instrument specifies which of these requirements will also apply to ATSS. The Forms are required to be filed by marketplaces when commencing to carry on business and must be filed by an ATS to report on certain activities and when ceasing to carry on business.

### ***Purpose of the Instrument and Policy***

NI 21-101 is intended to provide an appropriate regulatory framework within which traditional markets, such as exchanges, and new markets, such as ATSS, can operate. Companion Policy 21-101 CP sets out guidelines regarding the application of NI 21-101.

### ***Discussion of Instrument and Policy***

During the last ten years there have been numerous discussions regarding whether electronic trading systems should be permitted to operate in Canada and what their effect would be on traditionally recognized and regulated markets<sup>1</sup>. The debate centered on the causes and effects of fragmentation as well as on how to regulate these new types of entities. At the current time, exchanges, dealers and investors acknowledge that various types of electronic trading systems have developed in response to investor demand for different services and fee structures than are now provided by exchanges.

NI 21-101 and Companion Policy 21-101CP focus on how to regulate ATSS and how to minimize any negative effects of fragmentation through consolidation of information and order integration. Discussion of the relevant parts of NI 21-101 and Companion Policy 21-101CP will be divided into the following topics:

- (1) The concepts of marketplace and ATS;
- (2) Recognition of exchanges and quotation and trade reporting systems;
- (3) Regulatory choices for ATSS;
- (4) Regulatory requirements for ATSS that choose not to be an exchange or member of an exchange;
- (5) Information consolidation and market integration requirements for marketplaces;
- (6) Recordkeeping requirements and systems' capacity and integrity requirements; and
- (7) Carrying on business as an ATS within a jurisdiction.

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<sup>1</sup> See Background Paper entitled "Regulation of Alternative Trading Systems in Canada" attached to this notice which presents a brief history of the events regarding ATSS and summarizes the key issues. See also: *Request for Comments and Notice of Forum to Discuss "NETS" and Market Fragmentation* (1997), 20 OSCB 2565 (the Ontario Securities Commission published the request for comments and notice of forum on May 16, 1997) and *Summary of comments received in response to the Request for Comments concerning Non-SRO Electronic Trading Systems and Market Fragmentation* (1998), 21 OSCB 1443.

A section by section summary is set out in Appendix “B” .

## 1. **The Concepts of Marketplace and Alternative Trading System**

Part 1 of the NI 21-101 sets out a definition of “marketplace”. A marketplace is defined as an exchange, a quotation and trade reporting system and any other person or company that (a) constitutes, maintains or provides a market or facilities for bringing together purchasers and sellers of securities, (b) brings together the orders for securities of multiple buyers and sellers, and (c) uses established, non-discretionary methods under which the orders interact with each other and the buyers and sellers entering the orders agree to the terms of a trade. Part 2 of the Companion Policy 21-101 CP provides further explanation of this concept.

In developing the appropriate regulatory framework for ATs within the Canadian capital markets, the CSA have determined what is an ATS, how it differs from a traditional exchange, and which characteristics should require an ATS to be regulated as a recognized exchange. Historically, exchanges have brought together buyers’ and sellers’ orders for securities. As world markets have evolved, so have exchanges. They do not all perform the same functions or even have the same types of governance structures as they have had in the past. ATs also provide a marketplace for buyers’ and sellers’ orders.

As set out above, NI 21-101 provides a broad definition of “marketplace” that includes both exchanges and ATs. The definition of ATS then identifies certain characteristics that the CSA believe require an entity to be regulated as an exchange. The characteristics are: providing a listing function, carrying out market regulation, disciplining subscribers or providing a guarantee of liquidity through intermediaries such as professional market makers. Part 3 of Companion Policy 21-101CP states that if a marketplace lists securities, provides guaranteed liquidity, disciplines marketplace participants or carries out market regulation, then it would have to apply for recognition as an exchange. Subsection 6.4 (1) of NI 21-101 requires an ATS to notify the appropriate member of the CSA before it begins to do any of these functions. The ATS would then be required to apply for recognition as an exchange.

Traditional dealer activity is excluded from the concept of marketplace (and is therefore neither a characteristic of an exchange or an ATS) because such activity is not characterized as bringing together orders of multiple buyers and sellers through non-discretionary methods of order execution. Using internal systems to trade and manage orders does not cause a dealer to be an ATS or marketplace, if the dealer exercises discretion or judgement over customer orders. An example of systems that do not use non-discretionary methods are traditional block trading desks which retain discretion and frequently commit capital to satisfy customer needs. Subsection 2.1 (5) of Companion Policy 21-101CP identifies additional circumstances that are not considered to qualify a system as a marketplace: an issuer selling its own securities (one seller and multiple buyers), order routing systems and bulletin boards.

Subsection 6.5(1) of NI 21-101 describes another factor that could cause the members of the CSA to determine that a marketplace should be recognized as an exchange. If the volume of trading activity in a type of security reaches 40 percent of the average daily dollar value of the trading volume in that type of security traded in Canada, then by virtue of the level of trading on the system, and the importance of ensuring that access is provided to all investors, the CSA will consider whether the system should be considered to be an exchange and therefore regulated as an exchange. The CSA are of the view that if a trading system reaches the threshold, it is in a position to be the dominant market in some important segment of the securities market. This threshold is triggered based on any three of the ATs previous four calendar quarters. The ATS is required to notify the appropriate member of the CSA when it reaches the threshold.

**Question 1: Is 40 percent of the average daily dollar value of the trading volume in any type of security traded in Canada an appropriate threshold or should it be lower (for example, 10 percent or 20 percent)?**

There is another volume threshold set out in paragraph 6.5(1)(b) of NI 21-101. If the volume of trading activity reaches 50 percent of the average daily dollar value of the trading volume in any security *and* 5 percent of the average daily dollar value of the trading volume in any type of security traded in Canada, then, the CSA will consider whether the system should be considered to be an exchange and therefore regulated as an exchange. The CSA are of the view that if a trading system reaches this threshold, it is in a position to be a dominant market by achieving substantial activity in a specific issue and the CSA will consider whether the system should be regulated as an exchange. As set out above, the ATS is required to notify the appropriate member of the CSA when it reaches the threshold for any three of the previous four calendar quarters. The CSA are considering whether this requirement is appropriate and is specifically requesting comment on whether to retain the requirement.

**Question 2 : Should the CSA retain the second volume threshold set out in paragraph 6.5(1)(b) of the Instrument relating to 50 percent of the average daily dollar value of the trading volume in any security *and* 5 percent of the average daily dollar value of the trading volume in any type of security trading in Canada?**

The CSA are requiring an ATS to notify the appropriate member of the CSA when the volume thresholds set out above are reached. The volume thresholds are determined based on trading both inside and outside Canada. The CSA are requesting comment on the feasibility of an ATS to calculate the threshold specifically with respect to trading on marketplaces outside Canada.

**Question 3 : Is it feasible to require ATSS to calculate the volume threshold when dealing with foreign markets?**

## **2. Recognition of Exchanges and Quotation and Trade Reporting Systems**

Part 5 of Companion Policy 21-101CP discusses factors that a jurisdiction would review as part of the recognition process. Recognized exchanges today have regulatory responsibilities and requirements imposed upon them by the Canadian securities regulatory authorities. For the most part, the requirements set out in Part 5 are the standards that the Canadian securities regulatory authorities, as well as securities regulators outside of Canada, have applied and are currently applying to recognized markets. These standards, however, are not set out in securities legislation. In the course of discussions regarding ATSS, it was suggested that, if ATSS are given the ability to be regulated as exchanges, then the standards for being recognized as an exchange and requirements applicable to exchanges should be made clear. Part 5 of NI 21-101 contains requirements applicable to recognized exchanges and recognized quotation and trade reporting systems. Parts 7-11 of NI 21-101 provide some new requirements which will be applicable to all marketplaces. See discussion below.

## **3. Regulatory Choices for ATSS**

The definition of ATS provides that an ATS is not a recognized quotation and trading system or exchange. Therefore, if it chooses to be recognized as an exchange, it is not an ATS. Section 2.1 of NI 21-101 provides that an ATS is excluded from the Instrument if it is a member of a recognized exchange. Section 6.1 of NI 21-101 establishes the regulatory model for ATSS that are not recognized as an exchange or a quotation and trade reporting system and are not members of a recognized exchange. Thus, ATSS can choose to be recognized as an exchange, become a member of an exchange and be regulated in the same manner as any other exchange member, or become registered as a dealer which is a member of a "self-regulatory entity" (a term defined in section 1 of NI 21-101). At this time, the Investment Dealers Association of Canada (the "IDA") is the only body that would come within the definition of a self-regulatory entity. If the ATS chooses to be a member of the IDA it will be subject to the additional requirements applicable to ATSS (set out in Part 6 of NI 21-101) and marketplaces (set out in Parts 7-11 of NI 21-101).

Unless an ATS is recognized as an exchange, an ATS will not be subject to the requirements set out in Parts 3, 4 and 5 of NI 21-101 that are only applicable to recognized exchanges or recognized quotation and trade reporting systems. This is because the definition of “ATS” excludes recognized exchanges and recognized quotation and trade reporting systems.

4. **Regulatory requirements for ATSs that choose not to be an exchange or member of an exchange**

ATSs will be limited to trading “ATS securities”. Part 1 of NI 21-101 defines an “ATS security” as securities of reporting issuers, a derivative of such securities, government debt, or securities listed or quoted on markets outside of Canada that are set out in an Appendix to NI 21-101. When all jurisdictions have rulemaking or regulation making authority for commodity futures products, the CSA expect to extend the definition of ATS security to include commodity futures contracts traded on an exchange. The CSA are requesting comment on whether securities of a reporting issuer traded on an ATS should be limited to those securities that are listed on a recognized exchange. This would prohibit establishing an ATS for trading securities of reporting issuers that are quoted or reported on the Canadian Dealing Network.

**Question 4: Should trading of securities of reporting issuers on an ATS be limited to securities that are listed on a recognized exchange?**

The CSA are specifically requesting comment on which foreign markets should be included in the Appendix to NI 21-101.

**Question 5: Which foreign markets should be included in the Appendix to NI 21-101?**

Part 6 of NI 21-101 sets out requirements that are applicable to ATSs that are not recognized as exchanges or are not members of an exchange. Section 6.1 states that the ATS must be registered as a dealer and be a member of a self-regulatory entity which does member regulation and is not an exchange. Sections 6.2 and 6.3 set out the initial reporting requirements, ongoing reporting requirements and the reporting requirements upon ceasing operation of an ATS. In addition, subsection 6.4(1) requires an ATS to give notice to the appropriate member of the CSA if it begins to do any of the functions that the CSA generally consider to be functions of an exchange.

Section 6.6 prohibits a person or company that operates an ATS from principal trading. The CSA were concerned that without such prohibition, dealers with large volumes of trading might consider withdrawing from exchanges and operating as ATSs. The CSA have decided to impose this restriction after becoming aware that most systems operating in the U.S. do so only on an agency basis. The CSA believe that this requirement will help maintain a level playing field. The CSA specifically request comment on whether there should be a *de minimis* exemption for principal trading in order to encourage dealers to invest in ATSs. A restriction based upon the total volume of trading (e.g. 10 percent of the ATS' trading volume could be from principal trading of a participant dealer) or based upon the percentage of holdings in an ATS (e.g. 10 percent ownership in an ATS) could be used.

**Question 6: Should there be a *de minimis* exemption for principal trading in order to encourage dealers to invest in ATSs?**

5. **Information consolidation and market integration requirements for marketplaces**

In order to minimize any negative impact of having different marketplaces trade the same security, Part 7 of NI 21-101 requires information transparency and Part 8 of NI 21-101 requires market integration. The purpose of the information transparency and market integration requirements is to preserve the benefits of a centralized

market by taking advantage of technology. The goal is to provide the mechanisms for any investor to access the best priced order in Canada. This is described in more detail in the Consolidation Plan

Part 7 of NI 21-101 deals with information transparency requirements. Both pre-trade information (section 7.1) and post-trade information (section 7.2) must be provided to the “data consolidator” in real-time. As described in the Consolidation Plan, the data consolidator will be the person or company chosen by the CSA to consolidate pre-trade and post-trade information. Part C of this notice provides further details on how the CSA propose to choose the data consolidator and how it plans on implementing the establishment of information consolidation.

Section 7.1 requires any marketplace (recognized exchanges, recognized quotation and trade reporting systems, and ATSS) that displays orders to provide to the data consolidator information on such orders in the form of total disclosed volume at each of the five best price levels for each security traded. Disclosed volume refers to the portion of an order that is displayed in the marketplace. Volumes that are not disclosed or that are “reserve” or hidden volumes are not required to be displayed. Section 7.2 requires the marketplace to provide information on all trades executed (whether or not the orders had been disclosed) including the volume, symbol, price, and time of the trade.

An “order” is defined in Part 1 of NI 21-101 as a firm indication of a willingness to buy or sell a security. Part 6 of Companion Policy 21-101CP provides additional guidance regarding what is an “order” for purposes of NI 21-101. In order for parties to determine if the displayed price is in fact the best price, after taking into consideration the transaction fees, Part 9 of NI 21-101 requires that if the marketplace’s transaction fee is greater than \$0.005 per security purchased or sold, then the transaction fee must be included in the price displayed by the data consolidator.

Part 8 of NI 21-101 requires a marketplace to provide access for execution to any orders the marketplace has displayed through the data consolidator. The purpose of requiring market integration is so that any buyer or seller in a marketplace will have the right and the ability to access the best price offered or bid in any other marketplace, regardless of whether the buyer or seller is a marketplace participant in that system or not. The order will be executed in accordance with the execution rules (algorithms) of the marketplace receiving the order (*i.e.*, the marketplace where the passive order is located). See subsection 8.1(2) of the Instrument and section 11.1 of Companion Policy 21-101CP for further explanation. Subsection 8.1(3) of NI 21-101 requires the marketplace to provide “equivalent access” so that access is meaningful and section 11.2 of Companion Policy 21-101CP provides guidance as to the meaning of that term. In particular, subsection 11.2(2) states that using different technology to execute orders, responding more slowly to orders of non-participants, or charging fees that have the effect of creating a barrier to access would not be permitted. However, commercially justified conditions for execution (such as all or none, delayed delivery, “cash”) are, of course, permitted.

## **6. Recordkeeping requirements and systems’ capacity and integrity requirements**

The recordkeeping requirements allow the Canadian securities regulatory authorities to check compliance with the Instrument. Requirements for appropriate systems’ capacity and integrity requirements are necessary to reduce risks of disruptions of the Canadian market due to failure of a significant marketplace to have proper capacity, recovery and back-up capabilities. The purpose of these requirements is to promote and maintain the integrity of and confidence in the markets.

Part 10 of NI 21-101 imposes additional recordkeeping requirements for marketplaces regarding the identification of participants and daily trading summaries including time sequenced records of order information.

Part 11 of NI 21-101 specifies requirements regarding capacity estimates, stress tests of critical systems, review procedures for system development, contingency planning and an annual independent review. These requirements will be applicable to recognized exchanges, recognized quotation and trade reporting systems, and ATSS whose size reaches 20 percent of the daily dollar trading volume in any type of security. Part 13 of Companion Policy 21-101CP provides additional guidance on how to implement these requirements. While these requirements have not traditionally been imposed on marketplaces, the CSA believe that increased reliance on technology makes these requirements prudent business practice and a necessity to ensure the integrity of the Canadian capital market. Consideration may be given at a later date whether such systems' integrity requirements should be extended to dealers or service providers.

## **7. Carrying on business as an ATS within a jurisdiction**

The CSA believe that it is necessary to consider when an ATS would be carrying on business in a jurisdiction which would require compliance with NI 21-101 and NI 23-101. The CSA are seeking comment on whether and under what circumstances the mere placement of terminals or providing network access in a jurisdiction by an ATS would cause the ATS to be found to be carrying on business within the jurisdiction as opposed to providing "remote access." The Canadian securities regulatory authorities are considering this issue both in the context of remote access to trading systems within Canada and remote access to trading systems outside of Canada.

### **(a) Canadian ATSS carrying on business in a jurisdiction**

Staff of the members of the CSA ("CSA Staff") are of the view that the extent and nature of the contact with investors should determine whether an ATS is carrying on business in a jurisdiction. This would mean that if an ATS provided investors with direct access to its system, marketed its services to investors or provided training to investors, then the ATS would be carrying on business in any jurisdiction where such investors were located. However, if the ATSS' only contact was with dealers registered in the jurisdiction (hereafter referred to as "remote access"), then it would only be subject to the regulatory requirements in its home jurisdiction (hereafter referred to as the "Home Jurisdiction Approach."). In respect of a Canadian ATS carrying on business in another Canadian jurisdiction, the home jurisdiction of the ATS would be the jurisdiction where the ATS' head office is located, as set out on Form 21-101F2.

If the investor's access to the ATS is only through a locally registered dealer, then the investor could have sufficient protection because it has the benefits of local law and registration requirements, particularly if the dealer is a member of a self-regulatory organization recognized in the local jurisdiction. In addition, if the ATS is regulated in its home jurisdiction, the investor will also indirectly (and maybe even directly) receive the benefits of any regulatory requirements imposed in the home jurisdiction.

CSA Staff believe the Home Jurisdiction Approach works particularly well if the home jurisdiction is another Canadian jurisdiction and all of the CSA jurisdictions adopt NI 21-101 and NI 23-101. Under these circumstances, the regulatory requirements are the same but the reporting and oversight will be streamlined.

**Question 7: What type of activities should lead the CSA to the conclusion that an ATS is carrying on business in a jurisdiction?**

**Question 8: What limitations should be placed on the ATS' activities in a dealers' jurisdiction if the CSA adopts the Home Jurisdiction Approach?**

**Question 9: Are there any alternative approaches that should be considered by the CSA?**

(b) Foreign ATSS carrying on business in a jurisdiction

In recent years, several trading systems outside of Canada have proposed permitting access to their trading facilities. In limited circumstances, some trading systems have been permitted to provide terminals in Canada. For example, in Ontario, in September 1995, Instinet U.S. was granted registration as an international dealer, which permitted it to provide terminals to Ontario Designated Institutions (a term defined in Regulation 1015 to the *Securities Act* (Ontario)) to trade foreign securities which are not listed on a Canadian stock exchange directly on the Instinet network. This arrangement was permitted until the issues regarding ATSS were dealt with on a broad policy basis.

The CSA have been examining different alternatives for addressing these concerns. At this time, the Canadian securities regulatory authorities are considering whether an approach similar to that set out above is appropriate for trading systems that are located and regulated outside of Canada. Specifically this would mean that if a foreign ATS provided direct access to investors, marketed its services to investors or provided training to investors in a jurisdiction, then the ATS would be carrying on business in any jurisdiction where such investors resided. However, if the ATSS' only contact was with dealers registered in the jurisdiction, then it would only be subject to the regulatory requirements in the foreign jurisdiction which is its home jurisdiction. This would be similar to when a Canadian dealer contacts a foreign dealer to execute a customer's order in a foreign market. Currently, Canadian regulators permit this type of arrangement provided there is a regulated intermediary in the foreign jurisdiction which executes the trade. The CSA are specifically requesting comment on issues related to foreign ATSS carrying on business in a jurisdiction.

**Question 10: Should the foreign ATSS be required to be a regulated entity in its home jurisdiction? If so, must it be regulated under the securities laws of the home jurisdiction?**

**Question 11: Should access to the foreign ATS be through a Canadian dealer contacting a dealer that is regulated in the foreign jurisdiction (home jurisdiction of the foreign ATS)?**

**Question 12: Should this approach be limited to acceptable home jurisdictions, and if so what jurisdictions should be approved as acceptable?**

(c) Order Routing and Remote Access

Some dealers may only act as order routers, which means the main service they provide is the technology which enables a customer to direct an order to a market for execution. While such activity still requires the dealer to comply with the same registration requirements as other registered dealers, the level of service can be quite different from a full service dealer. The dealer can be little more than a communication link.

CSA Staff are considering whether the nature of the activities of the dealer should have an impact on permitting remote access without any further regulation of the foreign ATS. For example, should the CSA permit remote access through a dealer that does not provide investment recommendations.

**Question 13: Should the availability of the Home Jurisdiction Approach depend on the activities of the registered dealer in the jurisdiction where the investor is located?**



**Question 14: Should the answer to the above question depend upon whether the home jurisdiction is another Canadian jurisdiction or a foreign jurisdiction?**

CSA Staff are also considering whether the Home Jurisdiction Approach should be permitted if the only activity and purpose of a dealer is to direct orders from the customer to an ATS located in a foreign jurisdiction. Should the CSA allow a dealer to be set up as a Canadian subsidiary of the foreign ATS under a remote access model, or must the Canadian dealer be independent of the ATS?

**Question 15: Should the availability of the Home Jurisdiction Approach depend on whether the Canadian registered dealer is an affiliate of the ATS?**

Another example is the use of the international dealer registration in Ontario. CSA Staff is aware that foreign markets are attempting to provide access to their markets through foreign dealers which are registered as international dealers in Ontario. These international dealers route the orders to affiliates located in the foreign jurisdiction where the market is located. Although international dealers are limited in the scope of their activity, their regulatory requirements are also limited. The CSA are requesting comment on whether remote access should be permitted through international dealers or other categories of dealers which are not members of a self-regulatory organization.

**Question 16: Should remote access be limited to dealers which are members of a self-regulatory organization?**

**B. NATIONAL INSTRUMENT 23-101 TRADING RULES**

Currently, each of the established recognized exchanges have implemented trading rules which are designed to establish fair and equitable trade practices and to prevent abusive and manipulative trade practices. If ATSS are to be allowed to operate independently of recognized marketplaces, they must also follow similar trade practices for their marketplace participants. However, in a competitive environment, it is not appropriate that the rules for ATSS be set out by other marketplace participants. It is therefore necessary for the CSA to establish basic common trading rules that will apply across all marketplaces. NI 23-101 and Companion Policy 23-101CP sets forth common trading rules which will apply to trading on all marketplaces. NI 23-101 do not prohibit marketplaces from implementing additional rules.

NI 23-101 addresses two significant areas of trading practice in our markets. First, it sets forth the rules that will prevent participants from engaging in manipulation of prices or the creation of deceptive trading activity. For example, the rules establish short sale conditions. Short sales can be beneficial to the market as they can provide a stabilizing influence on market activity in order to prevent volatile price movement. In certain circumstances, however, short sales can be detrimental as they may be used as a tool for price manipulation. The short sale rule is intended to strike a balance between maintaining the beneficial aspects while at the same time preventing the detrimental aspects. Canadian exchanges have been applying different standards of short sale rules. The Toronto Stock Exchange, The Montreal Exchange and The Alberta Stock Exchange have used a "zero-minus tick" rule while the Vancouver Stock Exchange has used a zero-plus tick rule. The Canadian securities regulatory authorities consider that the higher standard of short sale rule, *i.e.*, the zero-plus tick rule, is appropriate to improve market stabilization and is also consistent with the current practices and rules adopted by U.S. markets.

NI 23-101 also sets out standards for achieving best execution for customer orders and for ensuring that fair

and ethical standards are applied across all markets. Specifically, the standards establish that participants' orders which are committed to the market must receive priority and prohibit the practice of crossing on the existing bid or offer without satisfying an order with previous standing. Further they prohibit customer client transactions under 10,000 shares unless the principal gives the client a better price than the order would have received in the existing market. The CSA were particularly influenced by the Report of Special Committee on Fragmentation produced by the TSE and concurred that the formulation of rules based on short term profit motives by member firms have eroded the price discovery mechanism in our markets and have serious implications for the stability of our capital markets.

## **C. THE CONSOLIDATION PLAN**

### **General**

The CSA believe that it is important to establish a framework that will allow competition between different marketplaces. However, it is also beneficial to maintain the benefits of having a centralized market. For this reason, in order to reduce the fragmentation caused by trading occurring in multiple marketplaces, it is critical to provide for consolidation of these marketplaces. The Consolidation Plan provides a detailed plan for consolidation, which will result in all investors having access to information across all marketplaces and all investors also having access to the best price available for execution across all marketplaces.

The Consolidation Plan proposes the establishment of a data consolidator who will be chosen by the CSA in response to a Request for Proposal ("RFP"). All marketplaces will be required to provide pre-trade and post-trade information to the data consolidator. The data consolidator will distribute a consolidated Canadian data feed based on the information provided by all of these marketplaces.

The Consolidation Plan further proposes that marketplaces be integrated in a phased process. Phase 1 of integration would require that each ATS be linked to a principal market for the securities that the ATS trades. Phase 2 would require that interlinkages between ATSs and the principal market(s) be accomplished through a market integrator (the "Market Integrator"). The Market Integrator may also be chosen through an RFP process following implementation of Phase 1.

The Consolidation Plan sets a framework for establishing a centralized market system which combines the positive benefits of new alternative technologies with traditional market structures.

### **Issues regarding consolidation**

#### ***(i) After hours trading – restriction on price***

During normal trading hours in the principal market, all participating exchanges, quotation and trade reporting systems and ATSs will send pre-trade and post-trade data to the data consolidator, subject to the trade-through policy. After market hours, ATSs will be allowed to operate and will be required to provide the data consolidator with quotation and transaction information. Several major U.S. markets have announced their intent to extend trading to evening hours. If they do, it is likely that Canadian exchanges would follow with similar changes.

The CSA are specifically requesting comment on two issues related to trading outside market hours:

**Question 17: Should ATSs be allowed to trade outside the closing bid-ask of the**

**principal market or should they be required to trade within the closing bid-ask on the principal market? Should this change if the exchanges extend trading to include evening hours?**

**Question 18: Should ATSS operate in the pre-opening period of the principal market or should there be a no-trade time period until the principal market has opened for trading?**

The Consolidation Plan contemplates that the data consolidator be supervised by a governing committee. The CSA are proposing that the governing committee discuss and determine extended trading hours required, the content of data during those hours and accommodations required for market opening and system maintenance and/or scheduled downtime.

**(ii) Depth of Market**

Section 7.1 of NI 21-101 and the Consolidation Plan provide that consolidated data include the volume at each price level for the best five prices on the bid and offer for each marketplace. This is based on the current practice in Canada of displaying five levels of market by price for most exchanges. The CSA also considered the following alternatives: (a) display only the best bid and offer prices, as is the practice in the United States (the NBBO or National Best Bid and Offer); or (b) display of volume and price for the entire depth of the book.

Showing only the best bid and offer provides marketplace participants with less information since it shows only one price level on each side of the market. The NBBO approach is the one followed by the U.S. Securities and Exchange Commission and goes back to the development of the National Market System. The development occurred at a time when technology was less advanced and electronic books were not common among exchanges.

Showing the best five levels provides more complete information about the market and is consistent with historical practices in Canada. By limiting the display to five levels, marketplace participants in each particular system would still have access to the complete order book in their own system. In this way, there is still a benefit in membership in individual systems.

**Question 19: Should the display of data include the volume at each price level for the best five prices on the bid and offer for each participant system?**

**(iii) Choice of Regulator Given Exchange Restructuring**

Market regulation (rules, surveillance, and enforcement) has traditionally been provided by exchanges. However, in an environment with ATS systems competing with exchanges, a mechanism for direct market regulation of ATSS must be established. Since ATSS will compete with exchanges, it will be necessary for the CSA to provide an overall structure that incorporates ATSS into the market oversight structure while not hindering the ability of ATSS to compete with exchanges.

Market regulation could be carried out by the CSA, an existing exchange, an existing SRO, such as the IDA, or a new SRO established for this purpose. A key issue in determining who takes on this role is which entities are best suited to perform this function and which entities have the best resources to successfully accomplish

it. Another key issue is that market regulation not hinder the effective operation of any marketplace participant because of conflicts of interests.

The CSA have spent significant time discussing this issue. As a result of this careful review, and until there is another acceptable regulatory option in Canada, the CSA have formulated the following provisions for market regulation.

1. The CSA will adopt NI 23-101, which will provide for a standardized and co-ordinated set of rules governing trade practices on all marketplaces carrying on business in Canada.
2. An ATS that chooses to be a member of the IDA, will be required to contract with an exchange of its choice for the exchange to provide surveillance and enforcement for the ATS. In this way, each ATS has some choice over the appropriate party to perform its surveillance while the exchanges have the opportunity to spread the costs of market oversight to the ATS for whom it performs this function. The CSA will be responsible for oversight of any conflict between exchanges and ATSs in the performance of these functions.
3. Where securities trade on multiple exchanges and are subject to regulatory oversight by multiple exchanges, those exchanges will be required to provide co-ordination of surveillance and enforcement activities on behalf of the ATS for the purposes of applying NI 23-101 across all participant systems.

The proposal as described above is based on the existing interlisted structure in Canada. However, if the exchanges' proposal for restructuring is adopted, then each issue will trade on only one exchange. This changed model has implications for regulatory oversight of ATSs. The CSA are specifically requesting comment on the following issues:

**Question 20: Should an ATS have to contract with the exchange on which a security is listed or should it still be able to choose the exchanges that will perform the market regulation function? This question should be considered from both of the following perspectives: pre-exchange restructuring and post-exchange restructuring.**

**Question 21: If an ATS is going to trade all listed equities (senior and junior) should it be required to contract with both exchanges for oversight or with only one? This question should be considered from both of the following perspectives: pre-exchange restructuring and post-exchange restructuring.**

**(iv) *Regulatory Halts***

The CSA are considering whether it is appropriate to require an ATS to halt trading in a security when there is a regulatory halt imposed by the market where the security is listed or quoted. The CSA are suggesting that, during any regulatory halt, the data consolidator cease to disseminate information on that security until the halt has been lifted by the market where the security is listed or quoted and the security has entered a pre-opening period.

**Question 22: Should any restrictions be placed upon an ATS when there is a regulatory halt imposed by the market where the security is listed or**

**quoted? Should it matter if a halt is imposed by a recognized quotation and trade reporting system?**

**D. SPECIFIC REQUESTS FOR COMMENT**

In summary, the CSA specifically request comment on the following issues:

- Question 1: Is 40 percent of the average daily dollar value of the trading volume in any type of security traded in Canada an appropriate threshold or should it be lower (for example, 10 percent or 20 percent)?
- Question 2: Should the CSA retain the second volume threshold set out in paragraph 6.5(1)(b) of NI 21-101 relating to 50 percent of the average daily dollar value of the trading volume in any security *and* 5 percent of the average daily dollar value of the trading volume in any type of security trading in Canada?
- Question 3: Is it feasible to require ATSS to calculate the volume threshold when dealing with foreign markets?
- Question 4: Should trading of securities of reporting issuers on an ATS be limited to securities that are listed on a recognized exchange ?
- Question 5: What foreign markets should be included in the Appendix to the Instrument?
- Question 6: Should there be a *de minimis* exemption for principal trading in order to encourage dealers to invest in ATSS?
- Question 7: What type of activities should lead the CSA to the conclusion that an ATS is carrying on business in a jurisdiction?
- Question 8: What limitations should be placed on the ATS' activities in a dealers' jurisdiction if the CSA adopts the Home Jurisdiction Approach?
- Question 9: Are there any alternative approaches that should be considered by the CSA?
- Question 10: Should the foreign ATSS be required to be a regulated entity in its home jurisdiction? If so, must it be regulated under the securities laws of the home jurisdiction?
- Question 11: Should access to the foreign ATS be through a Canadian dealer contacting a dealer that is regulated in the foreign jurisdiction (home jurisdiction of the foreign ATS)?
- Question 12: Should this approach be limited to acceptable home jurisdictions, and if so what jurisdictions should be approved as acceptable?
- Question 13: Should the availability of the Home Jurisdiction Approach depend on the activities of the registered dealer in the jurisdiction where the investor is located?

- Question 14: Should the answer to the above question depend upon whether the home jurisdiction is another Canadian jurisdiction or a foreign jurisdiction?
- Question 15: Should the availability of the Home Jurisdiction Approach depend on whether the activities of the Canadian registered dealer is an affiliate of the ATS?
- Question 16: Should remote access be limited to dealers which are members of a self-regulatory organization?
- Question 17: Should ATSS be allowed to trade outside the closing bid-ask of the principal market or should they be required to trade within the closing bid-ask on the principal market? Should this change if the exchanges extend trading to include evening hours?
- Question 18: Should ATSS operate in the pre-opening period of the principal market or should there be a no-trade time period until the principal market has opened for trading?
- Question 19: Should the display of data include the volume at each price level for the best five prices on the bid and offer for each participant system?
- Question 20: Should an ATS have to contract with the exchange on which a security is listed or should it still be able to choose the exchanges that will perform the market regulation function? This question should be considered from both of the following perspectives: pre-exchange restructuring and post-exchange restructuring.
- Question 21: If an ATS is going to trade all listed equities (senior and junior) should it be required to contract with both exchanges for oversight or with only one? This question should be considered from both of the following perspectives: pre-exchange restructuring and post-exchange restructuring.
- Question 22: Should any restrictions be placed upon an ATS when there is a regulatory halt imposed by the market where the security is listed or quoted? Should it matter if a halt is imposed by a recognized quotation and trade reporting system?

### **Anticipated Costs and Benefits**

NI 21-101 allows ATSS to compete with traditional markets, such as exchanges. When an environment is established that allows for competition among markets, then investors will have choices. The CSA are of the view that allowing such competition will stimulate innovation and encourage markets to offer better features and services to their members and subscribers and at lower costs. The Consolidation Plan will combine the positive benefits of competing systems while preserving the benefits of a centralized market.

NI 21-101 also provides improved market transparency for all marketplaces as well as interlinkage of those marketplaces so that all buyers and sellers of a security have access to the best price for execution.

The requirements regarding systems capacity, integrity and security of systems provide several benefits to the marketplace and to investors. Marketplaces are increasingly reliant on technology and most of their functions

are becoming highly automated. The ability of marketplaces to provide more reliable and consistent service in the market benefits investors and the markets.

NI 21-101 imposes costs on ATSS, exchanges and quotation and trade reporting systems as a result of the requirements imposed by NI 21-101, including application procedures, access requirements, the requirement to adopt certain by-laws and rules, the requirements relating to pre-trade and post-trade transparency and market integration, and the requirements relating to capacity, integrity and security of systems. In particular, the notice, reporting and recordkeeping requirements will require marketplaces to file certain additional information. The requirements relating to capacity, integrity and security will also impose costs. However, smaller ATSS will not be subject to the requirements relating to capacity, integrity and security of systems.

In the view of the CSA, the benefits outweigh the costs.

NI 23-101 benefits purchasers and sellers of securities in that they are designed to prohibit certain practices and to require other practices, all of which are necessary for the operation of fair and efficient capital markets. NI 23-101 imposes compliance costs on persons or companies subject to NI 23-101 in that it prohibits certain activities. It also imposes costs on marketplace participants in terms of the best execution rules and the rules restricting principal trading. It also requires marketplaces to monitor and enforce compliance with certain of the provisions of NI 23-101. In the view of the CSA, the benefits of NI 23-101 outweigh the costs.

## **Comments**

Interested parties are invited to make written submissions with respect to the National Instruments, Forms, Companion Policies and Consolidation Plan . Submissions received by October 1, 1999 will be considered.

Submissions should be sent to all of the Canadian securities regulatory authorities listed below in care of the OSC, in duplicate, as indicated below:

British Columbia Securities Commission  
Alberta Securities Commission  
Saskatchewan Securities Commission  
The Manitoba Securities Commission  
Ontario Securities Commission  
Office of the Administrator, New Brunswick  
Registrar of Securities, Prince Edward Island  
Nova Scotia Securities Commission  
Securities Commission of Newfoundland  
Registrar of Securities, Northwest Territories  
Registrar of Securities, Yukon Territory  
Registrar of Securities, Nunavut

c/o Daniel P. Iggers, Secretary  
Ontario Securities Commission  
20 Queen Street West  
Suite 800, Box 55  
Toronto, Ontario M5H 3S8

E-mail: [diggers@osc.gov.on.ca](mailto:diggers@osc.gov.on.ca)

Submissions should also be addressed to the Commission des valeurs mobilières du Québec as follows:

Claude St. Pierre, Secretary  
Commission des valeurs mobilières du Québec  
800 Victoria Square  
Stock Exchange Tower  
P.O. Box 246, 22nd Floor  
Montréal, Québec H4Z 1G3  
E-mail: [claudestpierre@cvmq.com](mailto:claudestpierre@cvmq.com)

A diskette containing the submissions (in DOS or Windows format, preferably WordPerfect) should also be submitted. As securities legislation in certain provinces requires that a summary of written comments received during the comment period be published, confidentiality of submissions cannot be maintained.

Questions may be referred to any of:

Louyse Gauvin  
Executive Assistant to the Chair  
British Columbia Securities Commission  
(604) 899-6538 or (800) 373-6393 (in B.C.)

Robert Hudson  
Manager and Senior Legal Counsel  
British Columbia Securities Commission  
(604) 899-6691 (800) 373-6393 (in B.C.)

Ross McLennan  
Director, Registration  
British Columbia Securities Commission  
(604) 899-6685 (800) 373-6393 (in B.C.)

Glenda Campbell  
Director, Legal Services & Policy Development  
Alberta Securities Commission  
(403) 297-4230

Eric Spink  
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Alberta Securities Commission  
(780) 422-1503



Barbara Shourounis  
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(204) 945-0605

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(416) 593-8257

Susan Greenglass  
Legal Counsel, Market Regulation  
Ontario Securities Commission  
(416) 593-8140

AnneMarie Ryan  
Consultant, Market Regulation  
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(416) 593-3669

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Director, Research and Market Development  
Commission des valeurs mobilières du Québec  
(514) 940-2199, ext. 4551

CSA Staff would like to thank Hugh Cleland for his guidance in the early stages of this project.

Dated at Calgary, Alberta on July 2, 1999.

Appendix A: **REGULATION OF ALTERNATIVE TRADING  
SYSTEMS IN CANADA**

**Prepared By AnneMarie Ryan  
For Canadian Securities Administrators  
June 1999**

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## **Section 1: EXECUTIVE SUMMARY**

**Significant discussion and debate has been carried out for over ten years on the appropriate regulatory framework under which Alternative Trading Systems (“ATs”) should be allowed to operate in Canada. This paper presents a brief history of the events regarding ATs and attempts to summarize the key issues on this topic.**

**As the investment industry has evolved in recent decades, technology has been a major influence on the nature of business operation. Academic analysis on the effects of technology has concluded that it provides great benefits for investors, increasing competition and providing greater transparency of markets.**

**In Canada, ATs have been allowed to operate in a restricted fashion. Concerns over market fragmentation have resulted in ATs being limited to operation only as members of an existing exchange. However, most market participants believe that the time has come to allow ATs to compete with traditional exchanges.**

**In assessing this issue, Canadian regulators have been particularly cognisant of recent developments in US markets, where the SEC has recently adopted new rules that permit ATs**

**to register as either exchanges or dealers, and further require that ATSS be linked to the National Market System. While Canada has several specific issues which need to be addressed, Canadian regulators have been particularly interested in US developments and believe that it is appropriate to follow a model closely based on the US approach.**

**In this paper, close attention was given to the attributes of ideal markets and to how these attributes could be applied in the Canadian context, to deal specifically with the issues of concentration, fragmentation and the future role of traditional exchanges.**

**The Canadian Securities Administrators (“CSA”) is setting forth, in National Instrument 21-101 “Marketplace Operations” and National Instrument 23-101 “Trading Rules” , a regulatory framework for marketplaces, which will combine these new markets based on technology, with traditional market structures.**

## **Section 2: BACKGROUND**

**Alternative Trading Systems (“ATs”) are Electronic Trading Systems (“ETs”).<sup>1</sup> ATs provide automated matching systems, which bring together orders from buyers and sellers, by using predetermined, established methods or rules under which such orders interact. They may operate a continuous auction book, a dealer market, a call market, or an anonymous match based on a price determined by the principal market. ATs have gained great appeal in a number of market segments, primarily because they have features and services not typically offered by traditional exchange markets. They have previously been referred to as Non-Exchange Trading Systems (“NETS”) and Proprietary Electronic Trading Systems (“PETS”).**

**Over the past decade, regulators in both Canada and the US have undertaken extensive research and review of electronic trading in order that they may establish an appropriate framework of regulation for ATs and incorporate these new systems into traditional market structures. This paper sets out the history of ATs and discusses the issues they raise for discussion in more detail.**

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<sup>1</sup> Electronic Trading System is the general term used to describe computer systems that automate all or part of the trade process. They may provide order routing between clients, brokers and/or exchanges or they may perform the execution matching typically provided by exchanges.

## 2.1 **Alternative Trading Systems in Canada**

**In 1988, Instinet Canada Limited (ICL<sup>2</sup>) purchased a seat on The Toronto Stock Exchange and applied for TSE membership. A group of TSE member firms strongly opposed Instinet's admission to membership and, following extensive discussions between the TSE and ICL, the Ontario Securities Commission ("OSC") was asked to intervene. In 1989, the OSC ruled that Instinet should be admitted to membership and that the TSE should appoint a Rule Review Committee to examine changes required to improve market quality and limit market fragmentation due to Instinet's inclusion. Instinet was restricted from installing terminals in Canada while the Rule Review Committee study was being conducted.**

**Subsequent to the Report of the Rule Review Committee, the OSC agreed to maintain the status quo provided that the TSE make the necessary rule changes recommended in the Report<sup>3</sup> and prepare an in-depth study of the market fragmentation issue. The Commission confirmed ICL's TSE membership and registration as a broker, subject to the same restrictions imposed by the earlier ruling.<sup>4</sup> Instinet commenced operation as a TSE member in 1993,**

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<sup>2</sup> Instinet Canada Limited is a subsidiary of Instinet Corporation, a wholly owned subsidiary of Reuters Group PLC.

<sup>3</sup> Since that time, the TSE has adopted most of the changes but did not make one of the most significant changes that dealt with the cross interference rule.

<sup>4</sup> ICL could serve Canadian accounts in Canadian and foreign securities but its customers were required to telephone orders to the ICL trading desk, where traders then keyed the orders into the

but was not permitted to install terminals on customers' desks in Ontario.

In May 1994, the OSC published a paper entitled "Electronic Trading Systems in Ontario" and in June 1994, sponsored a Forum to discuss the issues regarding NETS.

In early 1995, Versus Brokerage Services Inc. (VBSI), a subsidiary of Versus Technologies Inc. ("VTI") was registered as a broker. Under TSE Policy XXX,<sup>5</sup> VTI offered a terminal network permitting member firms, as well as institutions and foreign dealers to route orders to the TSE. VBSI participated in the network as a TSE member broker. In addition, Versus offered institutional clients the opportunity to participate in an electronic call (The Canadian Call) which is a call market facility integrated with the primary Canadian exchanges.

In September 1995, Instinet Corporation was granted registration by the OSC as an International Dealer, permitting it to provide terminals to institutions in Ontario to trade foreign listed securities, which were not interlisted on any Canadian exchange. The exchanges challenged this ruling and requested a formal hearing on the subject. The OSC denied requests from the major Canadian exchanges to hold a hearing on the matter and further

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Instinet system.

<sup>5</sup> TSE Policy XXX allows designated financial institutions to directly input their orders to a TSE member firm's order routing system. Designated institutions are defined under Policy XXX.



determined that a formal process should be put in place to obtain meaningful comment on the issue of fragmentation.

In January 1997, the TSE published its long awaited Report of the Special Committee on Market Fragmentation<sup>6</sup>, (The SC Report<sup>@</sup>), analysing the extent of fragmentation of equity markets in Canada. The SC Report analysed the causes and effects of fragmentation on the Canadian equity market. The report concluded that consolidated markets provide the highest quality, but that it is not always possible to satisfy the needs of different participants with one market structure. It further concluded that one of the most serious impacts from fragmentation was due to the “excessive diversion of smaller orders away from the TSE’S auction market.”<sup>7</sup> The SC Report recommended that ATSS be permitted to operate immediately as TSE members. The report further stated that it was inevitable that ATSS would be allowed to operate as competitors and that the TSE should take a leadership role in establishing an appropriate framework under which they should be allowed to operate.

The OSC published a Request for Comments and Notice of Forum on the subject. Subsequently, the British Columbia Securities Commission (“BCSC”), the Alberta Securities Commission (“ASC”), the Saskatchewan Securities Commission (“SSC”), and the Commission des valeurs mobilières du Québec (“CVMQ”)

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<sup>6</sup> TSE Special Committee Report, Market Fragmentation: Responding to the Challenge, Jan.1997

<sup>7</sup> TSE Special Committee Report, Market Fragmentation: Responding to the Challenge, Jan.1997, p.39

notified the OSC that they would like to participate in the meeting. The Forum was held in April 1998, and was presided over by the Chairs of the OSC, BCSC, ASC, SSC and CVMQ. Upon consideration of the comments at the Forum, responses to the request for comments, developments in other jurisdictions (particularly the SEC Rule on ATSS) and further discussions with market participants, the CSA is publishing today a Proposed Rule National Instrument 21-101, Marketplace Operations, and the Companion Policy 21-101CP as well as Proposed National Instrument 23-101, Trading Rules, and the Companion Policy 23-101CP.

## 1.2 ATSS in the United States

The CSA has followed developments on this issue in the US markets. The CSA has benefited from the research and analysis done by the Securities and Exchange Commission (“SEC”) and from discussions on key issues with the SEC. The CSA has attempted to develop an approach that is consistent with the SEC approach while also taking into account specific differences in the Canadian market.

Canadian exchanges are profoundly influenced by events occurring in the US markets. Over 200 Canadian companies are interlisted between Canadian and US markets and Canadian issuers increasingly look to US markets for listing. Because of

**their leadership role and their size relative to Canadian markets,<sup>8</sup> developments in the US have a significant influence on market structure issues in Canada. ATs and their regulation, is one of several key issues that reflect the continuing evolution of markets and is a topic which the Canadian investment community has followed and debated in great detail.**

**Although Canadian markets have historically been highly automated in the trade match and execution process,<sup>9</sup> automation of the entire trade process has evolved more rapidly in the US. Specifically, the establishment of a variety of alternative forms of trading systems has led the SEC to continually effect changes to accommodate an evolving market structure.**

**In the early 1970's, the SEC was dealing with a number of issues concerning regional exchanges, the growth of institutional pools of funds and issues related to the applications of technology. In 1975, the SEC enacted the Securities Act Amendments Act of 1975, which dealt with matters regarding competition between market centres and the benefits of technology.**

**The principal objective of the Act was to provide for "equally regulated, individual markets which are linked together to make**

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<sup>8</sup> The NYSE has \$8.9 trillion (US) in capitalization, NASDAQ has \$1.7 trillion (US) while the TSE, Canada's largest exchange has \$0.6 trillion (US).

<sup>9</sup> All Canadian exchanges operate totally automated electronic book systems rather than traditional open outcry trading floors. The TSE closed its trading floor in April 1997.

**their best price known and accessible."<sup>10</sup> It directed that a National Market System ("NMS") be established, to provide for fair access to market information and for the linking of markets. The establishment of a NMS<sup>11</sup> ensured that all participants would have access to information regarding the volume and price of bids and offers in all markets and that a National Best Bid and Offer (NBBO) would be published by vendors. Further, all participants would have access to "best execution" of their order, at the best bid or offer price across all markets. The Act also provided the SEC with the authority to regulate and oversee securities information processors (such as SIAC and NASDAQ).**

**Finally, and perhaps most importantly, it established that the use of technology to provide transaction services that might challenge traditional exchanges and their members not be discouraged. To this end, it required the NYSE and AMEX to remove rules which required that their members must make all trades in listed securities on the exchange.**

**Following the implementation of the NMS, the SEC was faced with the question of how to register computer-based networks that were designed to bring together and match buying and selling interests. In order to foster competition and to allow for the**

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<sup>10</sup> Securities and Exchange Commission Release No. 34-40760, Regulation of Exchanges and Alternative Trading Systems, P.8

<sup>11</sup> The NMS has three components: the Consolidated Tape, the Consolidated Quotation System and the Intermarket Trading System.

**development of these new systems, the SEC chose to register them as broker-dealers, rather than as exchanges. Regulation 17a-23 identified such systems as Electronic Communications Networks (“ECNs”)<sup>12</sup> and required them to keep certain records in addition to those normally kept by broker-dealers.**

**From 1979 until the early 1990’s, ATs were targeted at institutional investors and captured increasing trading volumes, primarily in NASDAQ issues. Institutions were permitted to trade as subscribers in ATs and exchange members were able to participate based on Rule 19-c3<sup>13</sup>.**

**In 1996, the SEC announced new rules regarding the handling of retail orders in US markets. The order handling rules required that:**

- a) all client limit orders better than the NBBO must be displayed**
- b) limit orders be displayed by specialists in their quote, and**
- c) market makers display the price of any orders that they enter into alternative systems that are not available to investors in general.**

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<sup>12</sup> ECNs are ATs which both match orders internally and connect to other markets for execution.

<sup>13</sup> Rule 19c3 provides that member firms may not be prohibited from trading off-exchange; US exchanges cannot require that members place agency orders in any listed security on the exchange. With respect to bids/offers made as principal, the exchanges were permitted to retain the prohibition on off-exchange trading for securities listed prior to April 26, 1979.

Since the changes effected by the order handling rules, the growth of trading in ECNs in US markets has grown at a **tremendous** steadily increasing pace. By the end of 1998, there were 9 major **ECNs** ATs in operation (and another 30 smaller ones) which collectively traded over 12 billion shares in 1998.<sup>14</sup> Latest estimates indicate that **they** ATs account for as much as 35% of orders in NASDAQ and close to 8% of orders in listed securities.<sup>15</sup>

Until recently, ATs essentially operated outside the exchange and National Market Systems. Their increasing popularity and growth led the SEC to further clarify the role of ATs in US markets and how they should be incorporated into the regulatory structure.

In December 1998, the SEC published **its** ~~their~~ final rule regarding the regulation of ATs, adopting a regulatory framework that would balance a centralized market with competition. The final rule gave ATs the choice to register as exchanges or to register as broker-dealers and comply with Regulation ATs. ATs which trade more than 5% of the volume in NMS securities must be registered as a broker-dealer with an existing SRO and they must be linked with a registered market in order to disseminate their best priced orders into the public quote display. In addition, they

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<sup>14</sup> See Appendix A, for trading volumes for major ATs and their respective trade volumes.

<sup>15</sup> R. Buckman and A. Lucchetti, *Electronic Networks Threaten Trading Desks on Street*, Wall Street Journal, Dec. 23, 1998

**must comply with the same market rules governing execution priorities that apply to members of registered exchanges. The SEC enacted these rules to “more effectively integrate the growing number of alternative trading systems into the national market system” and also to “provide an opportunity for registered exchanges to better compete with alternative trading systems.”<sup>16</sup>**

## **2.3 Industry Trends**

**The debate regarding ATs has taken place in the context of rapidly changing capital markets, not only in Canada, but also around the world. —Market participants face a number of trends, which are changing the way investors participate in the market, and, in particular, the manner in which they transact their business.**

### **2.3.1 Technology**

**Without question, technology and its applications has been one of the single greatest influences on capital markets over the past decade. Rapid changes in technology have had a profound impact on the nature of business operations. Evolving technologies in hardware, software applications and communications since the early 1980’s have impacted capital**

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<sup>16</sup> Securities and Exchange Commission Release No. 34-40760

markets and the rate of change continues to accelerate. Applications of technology to the trading process have given rise to totally electronic markets that are seamlessly integrated with order management systems as well as clearing and settlement systems. These markets now operate with increased efficiencies, able to transact unprecedented volumes at ever-increasing speeds. While these efficiencies have led to improved products and services for customers, they have also resulted in lowering the overall costs of transactions.

In addition to improvements to the efficiency of transactions, technology has provided investors with greater access to information about securities and the markets on which they trade. Advances in communications have reduced geographical boundaries, giving investors access to markets once separated by physical location. As a result, technology has enabled competition to develop that challenges the traditional structure of capital markets.

### **2.3.2 Globalization**

As investors have been able to access greater choice among markets, technology has led to increased globalisation of investment. Companies seeking to raise capital are no longer bound to local jurisdictions and have sought to raise capital in markets that offer them the greatest benefit. So, too, investors



**faced with increased choices have sought to improve their rates of return by investing in markets that offer the greatest opportunity for growth and development, regardless of geographical location.**

### **2.3.3 Institutional Consolidation**

**As a result of deregulation in financial service sectors, large financial service organizations now offer a breadth of financial services to investors and the distinction between the four pillars of finance (banking, trust, brokerage and insurance) has blurred. These new organizations operate large pooled funds on behalf of their customers, creating markets that are now dominated by institutional participants. Technology has also enabled growth in both the breadth of products offered and the growth of the large pooled funds. Index funds, global diversified funds, and quantitative funds operate large pooled funds based on technology.**

**In the US, in the last 5 years, capital under management has risen from \$500 billion to over \$4 trillion. The Toronto Stock Exchange, in its recent Blueprint For Success noted that “share ownership by institutional investors in Canada increased in the last 15 years from approximately 50% to an estimated 80% of the total equity market.” The result has been that institutional traders must**

**manage orders with great care and that market impact costs far exceed commission costs.**

### **2.3.4 Challenges to the Traditional Role of Intermediaries**

**The changes brought about by technological innovation have provided investors with greater choice than ever before. This innovation has established new and improved methods of operation and threatens traditional market structure and processes. As investors have gained greater access to markets and information, they have become less reliant on the traditional intermediary function supplied by brokerages. Traditional roles which brokers played have become replaced by technology. Research, once reserved for a broker's own client base, is now readily available from a variety of sources on the Internet. Indeed, brokers themselves have made access to their proprietary research readily available. Market information, once available only to investment professionals from market data vendors, is now provided free of charge by vendors, brokers and other information providers. Finally, in recent years, access to both primary markets and secondary markets has become commonplace using technology. The growth of discount trading and access to ECN networks<sup>17</sup> has allowed individual investors to effect their transactions with virtually no intermediation by brokers.**

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<sup>17</sup> ECNs, or Electronic Communications Networks, such as Island, BRUT, and Archipelago offer retail investors the ability to enter orders which may be matched against other retail orders in their own trade system or routed to another market, such as NASDAQ for display in the NMS.

**Institutional investors, who are seeking to match large block trades, are no longer satisfied with the traditional intermediation provided by block traders at investment firms. Managers of large block trades now seek the ability to manage their trade execution directly and to minimize market impact costs.<sup>18</sup> According to studies carried out by Plexus Group,<sup>19</sup> more than two-thirds of original institutional desk orders for a given stock exceed half of that stock's daily volume. The liquidity previously provided by brokers, acting as principal, has not kept up with the growth of large institutional orders. Institutional traders want to be able to find counterparties to their trades in systems that provide anonymity and do not force them to reveal the full size of their order to find the opposite side.**

### **2.3.5 Challenges to Traditional Exchange Structures**

**As regulators respond to providing a framework to incorporate alternative markets, the traditional monopoly position that most exchanges have held is no longer tenable or practical. Faced with increasing competition from these alternative markets, exchanges around the world are seeking ways in which to improve their efficiency and attract participants to their markets. The rise of alternative types of markets has also led market participants to**

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<sup>18</sup> Market Impact is defined as the negative effect on the price of the stock caused by market knowledge of a large order to buy or sell.

<sup>19</sup> Plexus Group is a consulting group which specializes in measuring the cost of transactions for institutional investors.---

**question what constitutes an exchange and what functions are intrinsic to its operation. In order to be more competitive, traditional exchanges have studied a number of changes to the way in which they operate to make them more competitive. First, exchanges have sought to merge or consolidate with other exchanges and benefit from combined liquidity and increased operational efficiencies. Second, many exchanges are moving towards demutualization and establishing a public/private corporate structure as opposed to a membership based organization. They are also seeking to provide access to institutional investors in more direct ways than ever before, whether by offering direct trading access to their market, by offering new market facilities such as OptiMark<sup>20</sup>, or through changing the ownership structure to broaden the scope of participation.**

### **Section 3: An Ideal Market Structure**

#### **3.1 Attributes of an Ideal Market**

**The strength and viability of a capital market are essentially dependent on two principal functions: first, the ability to support financing of enterprises by raising capital in the primary market and second, the ability to value publicly traded assets accurately and efficiently in the secondary markets. To the extent that**

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<sup>20</sup> The OptiMark system operates as a facility of an exchange, and offers an anonymous, non-disclosed call market, incorporating the exchange book with large block orders entered directly by institutions. OptiMark currently is in operation at the Pacific Coast Exchange and has agreements to license their technology with Nasdaq, Osaka and The Toronto Stock Exchange.

**market structure supports these fundamental functions, that market structure will provide for a capital market that meets the needs of market participants. In determining the appropriate overall structure in the Canadian context, the CSA's objective has been to ensure both public confidence in the marketplace and investor protection.**

**The issues surrounding market structure and how best to achieve an ideal market have been studied in recent years both in Canada and in the US by a number of market participants and academics. The TSE, in its Report of the Special Committee on Market Fragmentation, published in 1997, adopted a model (known as the Kirzner Model)<sup>21</sup> which set forth a framework describing the attributes of an ideal market. These attributes were defined to be Immediacy, Liquidity, Transparency, Price Discovery, Fairness, Integrity of the Credit Ring and Integrity of the Market. This model has been used in much of the debate in this country on the appropriate framework for ATs and exchanges to operate. In examining this model and much of the other market structure theory, the characteristics of an ideal market essentially fall into two broad categories, "Integrity of the Market" and "Efficiency of the Market". All of the attributes described in the Kirzner model fall within these broad categories, with certain attributes having a higher value and greater impact than others.**

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<sup>21</sup> The ideal market model was named for Eric Kirzner, Professor of Finance at the University of Toronto, and who acted as was the Chairman of the Special Committee

### **3.1.1 Integrity of the Market**

**The Integrity of the Market will be dependent on public confidence and perception that the market operates in a fair and ethical manner. Investors and the public, in general, must believe that all participants have equal access to accurate and timely information about the issues being traded. Marketplaces that have a high level of integrity will have effective practices regarding disclosure of issuer information to all participants.**

**Participants must believe that they are not unfairly discriminated against, as compared to any other set of participants (including insiders) in their ability to effect transactions in the market-place. The marketplace will have rules that are perceived to apply fair and equitable principles by which transactions are executed, once again, serving all participants equally. In addition, information concerning orders and transactions in the marketplace must have a high degree of transparency. Markets are determined to be transparent when they make information about orders (pre-trade) and transactions (post-trade) in the marketplace available to the public on a real-time basis, so that all participants have equal access to accurate and timely information.**

**Finally, participants must also have a high degree of trust that transactions in the marketplace are being executed through**

**trustworthy counterparties and that the transaction will be completed and settled in a satisfactory manner (this is generally referred to as the Integrity of the Credit Ring).**

### **3.1.2 Efficiency of the Market**

**The Efficiency of the Market refers to the ability of any participant to be able to execute a transaction quickly and easily, at a price which accurately reflects supply and demand with minimum transaction costs. In terms of the Kirzner model, this means that the market must have immediacy, liquidity, an effective price discovery mechanism and low transaction costs.**

**Immediacy will mean that a transaction can be effected quickly; i.e., that a transaction can be executed in a relatively short period of time without negatively impacting the price received. This concept is closely linked with liquidity which is normally described as the ability to purchase or sell a security at or near the last sale price and will be dependent on the depth, breadth and resiliency of the market. When a market does not have liquidity and immediacy, transactions become difficult to execute and/or result in price volatility which produces inefficient pricing for participants.**

**When a market has an effective price discovery mechanism, buyers and sellers are able to execute their transactions at prices that accurately reflect true supply and demand as well as the**

**market's assessment of the value of the security. Typically, price discovery mechanisms fail when there is unequal information disclosure among participants, when the price is determined based on incomplete information about supply and demand or when one or more parties are able to engage in fraudulent or manipulative practices.**

**Finally, an efficient market is one in which participants are able to execute transactions at minimum cost. Transaction costs are typically measured in terms of the transaction fee charged (which may be either the brokerage commission or dealer mark-up charged) and the market impact cost. Market impact is generally believed to be the more significant (and often hidden) component of the transaction cost; it is normally defined as the difference between the market price of the security before an order was placed and the price received for execution upon completion of the order. While transaction fees have been driven steadily lower in recent years as a result of the deregulation of commission rates and through efficiencies derived from technology, market impact costs have risen dramatically. Market impact costs have risen due to the growth of institutional holdings and the increasing difficulty in effecting large block transactions.**

### **3.2 Academic Analysis/Viewpoints**

**As regulators have sought to respond to the ever-increasing use of technology in the investment industry, their primary goal has**



**been to address issues of competition and investor interest. To a large extent, they have been motivated by the anticipation of important opportunities that might be provided by emerging technologies.**

**Heated public discussion around the appropriate regulatory structure, which would incorporate these technologies into the traditional market structure, has generated academic literature focussed on securities markets and market structure. The impact of technology on securities markets and on the role of brokers and dealers has also generated a number of academic studies. The results of these studies have brought into question many of the conventional assumptions about the appropriate structure of exchanges and other markets, as well as the appropriate regulatory environments.**

**Analytic and empirical studies have focussed on topics as broad as market fragmentation and price discovery to narrower ones such as the price/time priority, the nature of limit orders, and minimum spreads. The following summarizes some of the key topics discussed by academics that are relative to the discussions around the attributes of an ideal market and the appropriate market structure to support this market.**

### **3.2.1 Benefits of Electronic Trading**

**Academic analysis is universally in favour of the changes brought about by the application of technology to the trade process and, in particular, to electronic trading. Peake, Mendelson and Williams did the first comprehensive analysis on the topic of computer-based trading in 1976.<sup>22</sup> This study proposed a national electronic book and greatly influenced future developments in electronic trading systems. One of the first exchange computer trading systems was the CATS system,<sup>23</sup> developed by the TSE and implemented in 1977. CATS was adopted by many other exchanges including Paris, Madrid, and Brussels, and was used as the model for other systems for many years.**

**Benefits based on the use of electronic trading systems include:**

- Ability to handle increased levels of volumes**
- Ability for markets to compete over geographical boundaries**
- Increased transparency of information**
- Expanded dissemination of information**
- Increased access to markets**

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<sup>22</sup> The study, "Towards a Modern Exchange: The Peake-Mendelson-Williams Proposal for an Electronically Assisted Auction Market", by Junius Peake, Morris Mendelson and R.T. Williams was published in ~~E. Bloch and R. Schwarz~~, *Impending Changes for Securities Markets: What Role for the Exchanges*, **E. Bloch and R. Schwarz**, JAI Press, 1979.

<sup>23</sup> CATS stands for Computer Assisted Trading System.

- **The seamless execution of the trade process from the point at which the investment decision was made to the completion and settlement of the trade**

**In addition to these benefits, electronic trading has also been a key factor, in enabling new types of trading to develop; specifically, trading in derivatives, as well as program and basket trading. Electronic trading is believed to have contributed to the huge growth of pooled funds that dominate the market. In recent years, electronic trading has given rise to alternative markets, which challenge traditional markets, such as exchanges, and have provided market participants with new products, features and services not typically offered by traditional exchanges.**

### **3.2.2 Appropriate Implementation of Systems**

**When technology has been applied to the trade process, the most successful implementations have involved a reworking of the business processes themselves. Effective applications of technology should not merely replace the steps once carried out in a manual process. The development of trading systems has been a learning process for markets and for participants alike. Business processes must change to incorporate new systems and to achieve the maximum benefit that technology offers. This issue is discussed by Amihud and Mendelson who further believe that markets must not only re-engineer the process and**

**procedures but must also go about development in a thoughtful, cohesive fashion, determining an overall architecture for trading systems which takes into account ongoing needs for future enhancement. They contend that exchanges have largely approached automation in an unplanned, unsynchronised manner, resulting in high costs of development and onerous barriers to entry. “The piecemeal development of Exchange’s automated systems and the lack of a well-planned integrative approach impose a very high cost on trading institutions that interface with the Exchange’s systems.”<sup>24</sup> As technology has changed rapidly over the years, exchanges have been forced to make changes to systems designed to meet long outdated demands.**

### **3.2.3 Competition**

**The academic literature strongly suggests that competition has been a positive factor for the investment industry and that, in particular, challenges from ATs to traditional exchanges have important benefits for investors. Traditional structures such as exchanges have had strong incentives to resist technology and innovation, which might decrease their intermediary power. Several studies point out that the role of the regulators should be to establish a framework that will allow competitive markets and**

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<sup>24</sup> Yakov Amihud and Haim Mendelson, “Liquidity, Volatility and Exchange Automation”, *Journal of Accounting, Audit and Finance*, Volume 3, Fall 1988.

engenders competition between various trading environments. In its Market 2000 report, the SEC pointed out that “competition among these market centres provides many benefits for the users of the markets.”<sup>25</sup> Further, in response to exchanges’ fears that multiple markets would lead to fragmentation, the SEC countered that “dispersion of order flow among market centres has not impaired price discovery or market quality”.<sup>26</sup> Competition has forced exchanges to be more responsive to the needs of market participants and has enabled technological innovation to move forward.

### 3.2.4 Market Microstructure

In recent years, great consideration has been given to the specific processes used within one market as opposed to another and the effect that those processes have on the overall quality of the market. Many academics have suggested that markets must be re-engineered and redefined based on technology and have chosen to refer to this approach as “technostructure”. It is clear that a number of elements used in the systems design of a market will impact the effectiveness of that market.

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<sup>25</sup> Securities and Exchange Commission, *Market 2000 Report*, Securities and Exchange Commission, January 1994

<sup>26</sup> Securities and Exchange Commission, *Market 2000 Report*, Securities and Exchange Commission, January 1994.

**As an example, when the TSE first developed its pioneer CATS trading system, trading rules were defined specifically to take advantage of the new technology and rules were based on a strict price/time priority. While on a manual floor, it was often difficult to determine who had arrived at the post first (hence the common practice of sharing stock or pro-rating), in a computer system, it was always possible to determine which order had entered the market first (if even by a millisecond). Market theorists believe that the advent of trading systems based on strict price/time priority provide a vastly more efficient market and have offer wide access to unsubsidised liquidity providers, thus diminishing the need for traditional market maker roles.<sup>27</sup>**

**In general, markets will have improved quality, meaning a greater degree of liquidity and immediacy, when their structure encourages participants to place orders in their electronic book. Markets which provide no benefit to being in the system first will find, over time, that participants will hold back orders and will develop other ways of matching trades (as for example, in an “upstairs” market).**

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<sup>27</sup> H.R. Stoll, *Affirmative Obligation of Market Makers: An Idea Whose Time Has Passed?*, Vanderbilt University, July 1997

## **Section 4: Market Structure**

### **4.1 Objectives**

**In assessing the appropriate framework for a revised market structure, it is important to determine the role that the regulator should play. Industry participants generally contend that the appropriate role for the regulator is to provide an environment that fosters innovation and competition, thus letting competitive forces drive the evolution of market structure. The regulator should not try to define the perfect market structure but should allow healthy competition among participants to foster innovative developments that will benefit investors. The CSA agrees with the approach taken by the SEC in its Market 2000 Report, which sets forth that the principal duty of the regulator is to “cultivate an atmosphere in which innovation is welcome, without dictating a particular structure”.<sup>28</sup>**

**Historically, exchanges were established to provide a facility for buying and selling interests to interact. Brokers, acting on behalf of the buyers and sellers, met in a central location, which provided a price discovery mechanism. When demand and supply were not always evenly matched, the custom of providing intermediaries such as jobbers or specialists became common in order to**

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<sup>28</sup> Statement by the SEC upon release of Market 2000 Report.

**provide immediacy for participants. Securities legislation developed in North America to provide a framework for these exchange structures. However, in the last twenty years, technology has provided capabilities and services not envisioned when securities legislation established the traditional exchange structures.**

**Securities legislators are now faced with the task of allowing competition to traditional markets and allowing innovation based on technology to develop. The challenge is incorporate new competitors into a regulatory structure that takes advantage of the benefits offered by technology while preserving the fundamental value of a strong centralised market.**

**In addition, regulators must establish general guidelines for all markets about fair and equitable practices. In considering how best to establish this new framework, several key issues must be addressed in the Canadian context.**

## **4.2 Issues**

### **4.2.1 Fragmentation**

**When trading in a particular security takes place in multiple locations rather than in a central marketplace, then fragmentation is said to have taken place. Fragmentation of a market can be either external or internal. External fragmentation occurs when**



**alternative markets are established which compete with the primary market and take trading volume away from the central market. Internal fragmentation takes place when market participants find ways to match trades away from the central process.**

**The issue of fragmentation has been central to the discussion about an appropriate framework for ATSS. When ATSS first developed, there was strong opposition in Canada to allowing them to operate and great concern that the relatively small Canadian equity market would be severely damaged by fragmentation. However, in order to assess the impact of ATSS, it is important to look at the causes of both internal and external fragmentation.**

**External fragmentation will occur when the same securities trade in different locations. However, prior concerns about the effects of fragmentation are largely unfounded in the context of a consolidated market. The negative effects of external fragmentation are mitigated when participants have access to information across markets and have the ability to access those markets. This is precisely the issue that the SEC dealt with over twenty years ago when they established the National Market System. In establishing the NMS, their objective was to provide for “equally regulated, individual markets linked together to make**

**their best prices publicly known and accessible.”<sup>29</sup> In its Market 2000 Report, the SEC observed that “dispersion of order flow among market centres has not impaired price discovery or market quality.”<sup>30</sup>**

**Internal fragmentation already exists in the Canadian equity market as a result of dealers internalising retail order flows and trading in the “upstairs market”. However the causes of internal fragmentation are routed in the trading rules adopted by the exchanges themselves and can be addressed directly by the exchanges.<sup>31</sup>**

#### **4.2.2 Competition**

**As discussed above, there is a belief among market participants that the regulators should not define or interfere with market structure. Regulators should establish an environment that allows for competition among markets, so that investors will have choices. Market theory suggests that allowing such competition will stimulate innovation and encourage markets to offer better features and services to their members and subscribers.**

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<sup>29</sup> SEC Release No. 34-40760, December 1998, Page 8.

<sup>30</sup> SEC Market 2000 Report

<sup>31</sup> TSE Special Committee Report on Market Fragmentation, Page.30

**Because participants in traditional exchange markets have an incentive to resist technology and innovation that might decrease their intermediary power, regulators must allow competition so that innovators can develop and move forward. Observers of US markets, which have allowed competing ATs to operate for some time, have concluded that competition between markets has been beneficial; as noted by the SEC in its Market 2000 Report, “competition between market centres provides many benefits for the users of the markets.”<sup>32</sup>**

#### **4.2.3 Consolidation**

**In the Market 2000 Report, the SEC put forth the view that the effects of fragmentation could be offset by appropriate consolidation of the markets. Consolidation of multiple markets is critical to preserving an effective price discovery mechanism across competing systems. Consolidation of the markets consists of two primary functions: data consolidation and market integration.**

**All participants in the markets must have full and complete access to information about the markets. Data consolidation will ensure that information about activity in all systems is available to any**

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<sup>32</sup> SEC Market 2000 Report

**participant. This includes pre-trade information (the volume and price of bids and offers in each market) and post-trade information (the record of all trades that have taken place in all markets).**

**In addition, all participants must have equal access to the best price for execution across all markets. Market integration will ensure that participants who enter an order into one system will have access to the best price available in any system at the time of execution.**

**The CSA believe that it is critical to provide for a Consolidated Canadian Market if ATs are allowed to operate in competition with traditional market structures.**

#### **4.2.4 Regulation of ATSS**

**If ATSS are to operate in an environment where they are not required to be members of an existing exchange, as they are now, and are allowed to operate markets that compete with exchanges, then they must also be regulated in some fashion. In today's markets, participants are subject to both member regulation and market regulation. Member regulation will typically include registration of participants, certification and oversight of sales activities. Market regulation will include several related functions: establishing rules regarding trading practice, surveillance and enforcement.**

**After considerable discussion on this topic, most observers believe that the time has come for a suitable framework to be developed which will include ATSS within an appropriate regulatory framework but will not force them to be regulated by the very systems against which they compete. A recent study carried out for The Toronto Stock Exchange at the University of Toronto, concluded, "it will be hard for the Exchange to be seen simultaneously as an independent regulator of, and a vigorous competitor to, proprietary trading systems"<sup>33</sup>. However, it is also accepted that ATSS must be subject to oversight and should not**

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<sup>33</sup> Professors Daniels, Trebilcock, Halpern and Macey, *The Toronto Stock Exchange and the Public Interest: A Paradigm in Transition*, University of Toronto, 1998, Page 135

**be allowed to operate in competition with the exchanges outside of the self-regulatory structure.**

**The matter of how the regulation of ATSS should be carried out becomes critical. If ATSS are to be somewhat independent of the exchanges, then another SRO must regulate them. In Canada, at this time, the IDA performs member regulation. However, the IDA does not perform market regulation and there is no body independent of the exchanges that performs market regulation. The CSA is of the view that that market regulation must be performed by an entity that has the knowledge and expertise to provide effective oversight and is recognized to perform that function by the securities regulators.**

**In the United States, ATSS are able to register as dealers subject to oversight by NASD-R. NASD-R is the regulatory arm of the NASD and, while the same parent corporation that owns and operates the NASDAQ stock market owns it, the regulatory arm is a separate entity that has its own board of governors and management team. Clearly, in Canada, it would be preferable to have an independent self-regulatory organization (“SRO”) that could provide both member regulation and market regulation.**

**As stated previously, market regulation consists of three functions: establishing rules, surveillance and enforcement of those rules. If there is to be fair and consistent competition between alternative markets and traditional exchanges, then the**

**regulators must establish framework rules. Until there is an alternative independent choice for regulation in Canada, surveillance and enforcement of the market regulatory framework will be carried out by the SRO's that have been recognized to perform that function. To deal with competitive issues, however, ATs will be permitted to choose the SRO that will perform their market regulation function. Allowing ATs the opportunity to choose also gives the exchanges an opportunity to compete based on services and to recapture some of the costs they incur as self-regulatory organizations.**

#### **4.3 Specific Issues in the Canadian Market**

##### **4.3.1 Concentration**

**A few large firms dominate the Canadian securities market. In particular, the five bank-owned full-service brokerages account for over 50% of trading volumes and the top 10 firms represent over 80% of trading volumes. This concentration raises concerns over the ability of a small number of firms to impact our capital markets. Specifically, in relation to alternative trading systems, market observers have expressed concerns about the effect on the market if one or more large dealers set up their own ATS system for their customers and remove their order flow from the exchanges. In order to decrease the possibility of dealers finding**

**this an attractive option, they have suggested that ATSS be permitted to act as agents only and not be allowed to trade on a principal basis with their own customers.**



#### **4.3.2 Internal Fragmentation and Reduced Liquidity**

**For the most part, external fragmentation (as defined above) in Canada has been held off by the exchanges' insistence that alternative markets not be allowed to operate because they would cause fragmentation in our relatively small market.**

**Internal fragmentation, however, is a problem in our market. Internal fragmentation occurs when all orders are not committed to a central location so that they are not included in the price discovery process and buyers and sellers do not all have the opportunity to interact with all orders.**

**Over the past ten years, the TSE has seen a decline in the relative percentage of orders entered into the electronic book and a gradual but steady increase in orders which are matched off-exchange and then “printed” on the exchange. Although these trades are included in the total volumes reported for the exchange, they do not contribute to the liquidity of the market. When the majority of orders are matched outside of the electronic book, this means that a relatively small number of orders are setting the bid/ask price level and being used for price determination for off-exchange order matches. The causes of this migration of orders away from the exchange are many, but they have been directly influenced by changes in TSE trading rules over the past 10 years. TSE rule changes have led directly to**

**“upstairs trading” of block orders and to internalization of retail order flows and therefore internal fragmentation.**

**As institutional participation in the market has grown, institutions have found it increasingly difficult to match large blocks of stock. Institutions have also been concerned about showing the full size of their orders and suffering the negative effects of market impact when others are aware of their intentions to purchase or liquidate a large block. As a result, specialized institutional trading desks developed the practice in the 1980’s of advertising their large orders (“shopping blocks”) in order to put together large block crosses, thus earning the broker two commissions when he was able to put together a match. In addition, dealers were called upon frequently to use their own capital to supply liquidity for large trades. TSE rules have evolved over time to accommodate crosses<sup>34</sup> and customer-principal trades<sup>35</sup>. Critics of the rules have said that TSE rules do not protect orders in the market and that they specifically encourage dealers to make deals off-exchange and to use the exchange merely to “print trades”.<sup>36</sup>**

**The lack of liquidity in the exchange book has been further impacted by the large retail houses internalising their order flow**

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<sup>34</sup> Prior to 1970, a put-through was required to give up 15% of the volume to orders on the bid or offer.

<sup>35</sup> In 1975, client-principal trades were only allowed over \$400,000. The rule was amended in 1977 to allow trades over \$100,000, subject to displacement and client priority. In 1984, the dollar amount restriction was removed as long as the client received price improvement; in 1985, client principal trades were allowed and only needed to equal the bid-offer.

<sup>36</sup> This criticism was noted in a survey of US institutions regarding trading practices in Canada in the TSE Special Committee Report on Fragmentation.

**and acting as a principal on trades with their own customers. Changes to the TSE client principal trade rule in 1985 meant that dealers could buy from their customers at the bid and sell to them at the offer, thus taking the spread. This practice was further encouraged when the TSE implemented changes to accommodate Order Management Systems, which then enabled member firms to manage their order flow and route orders away from the exchange to their trading desks. The SC Report on Fragmentation cited this as one of the principal causes of reduced order flow to the exchange and recommended changes to the client-principal trade rules.<sup>37</sup> The SC Report expressed concern that “internalization negatively impacts market quality” and that “in the long run, the continuous pursuit of parochial interests by member firms could act to the detriment of the TSE overall”.<sup>38</sup>**

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<sup>37</sup> The Report recommended that dealers be required to immediately enter orders of 1200 shares or less to the electronic book and that client-principal trades of 5000 or less only be allowed when the client received a price better than the existing bid/offer. These changes were adopted in 1998.

<sup>38</sup> TSE Report of the Special Committee on Fragmentation, Page 75.

## Section 5: Recent Developments

### 5.1 Demutualization

In October of 1998, The Toronto Stock Exchange published its “*Blueprint for Success*”, outlining an analysis of the challenges and threats facing it as Canada’s senior equities exchange. The paper outlined a new strategic direction for the TSE, recommending specifically that the exchange adopt a new ownership and governance structure. This new structure would see a restructuring of the member-owned TSE into a shareholder-owned, for-profit corporation, which would be governed by a Board of Directors, composed of increased representation from outside the investment dealer community.

**On June 10, 1999, the Board and membership of the TSE is expected to vote to proceed with on-demutualization. in June 1999. This proposed change decision reflects the exchange’s changing vision and its response to increasing competition from other markets, inside and outside of Canada. It is the view of the CSA that the implementation of a new corporate structure will not by itself change the nature of the TSE’s operation. The TSE will continue to perform key functions that are intrinsic to operating as an exchange. As a result, the CSA believes that the TSE should continue to be regulated as an exchange and accept its public interest mandate.**

## **5.2 Exchange Restructuring**

**In March 1999, The Toronto, Montreal, Alberta and Vancouver Exchanges signed a memorandum of Agreement to restructure exchange activities along lines of market specialization. Under terms of the agreement, the TSE would become the senior equities market in Canada, the ME would assume responsibility for the derivatives market, and the ASE and VSE would merge to form a new Canadian junior market which would include junior issues listed on the ME and the Canadian Dealing Network (“CDN”). The intent of the restructuring by the exchanges was to allow each exchange to focus on core strengths, to minimize duplication of investments in infrastructure and services, to streamline activities for member firms and to allow the exchanges to compete more effectively in a rapidly changing environment.**

**If competition between exchanges is reduced, then investors will face fewer choices than they have today. It becomes even more important that ATSS be allowed to operate independently of exchanges and to offer competitive services and markets, to maintain investor choice.**

**Under the restructuring proposal, consolidation of markets, in fact, becomes easier since each ATS will only have to connect to the principal exchange for the securities it wishes to trade. Exchanges themselves will not have to connect to other**

**exchange markets for order integration, as they would have for interlisted issues.**

**The more complex issue becomes that of regulatory oversight. Until there is an independent SRO who could perform market regulation in Canada, ATs will have to contract with an existing exchange to perform that function. It clearly would be preferable for ATs to have several alternatives in the choice of regulation. On the other hand, it is also important that the SRO chosen to perform regulation have the experience and knowledge to effectively perform that function. The exchanges have expressed the view that ATs should be required to contact with the exchange where issues are listed. This would mean, for example, that an AT trading junior issues would be required to contract with the new junior exchange rather than being able to choose either the TSE or the ME as an alternative. The question becomes more complex when one considers that an AT may wish to trade a variety of issues. If an AT were trading both junior and senior equities, would it be required to have market regulation performed by both the junior and senior equity exchanges or by only one? The key issue for regulators, in a restructured environment, is that ATs must contract with an SRO who is recognized and qualified to perform the regulation function, but exchanges who are operating competing marketplaces must not be allowed to use their regulatory power to hinder fair competition.**

The CSA is reviewing the implications of the exchange restructuring proposal for **National Instrument Rule 21-101 and National Instrument 23-101** and will continue to amend the **instruments Rule and/or policies**, as required, when further detailed plans are set forth by the exchanges and when the proposal **has received** all of the member and regulatory approvals required.

## Appendix B

### Summary of National Instrument 21-101

National Instrument 21-101 has 12 parts.

*Part 1.* Section 1.1 contains the definitions of terms and phrases used in the National Instrument that are not defined in or interpreted under a definition instrument in force in the jurisdiction. The terms "ATS", "ATS security", "marketplace" and "marketplace participant" are discussed in Part A of the Notice.

*Part 2.* Part 2 provides that the proposed Instrument does not apply to a marketplace that is a member of a recognized exchange in any jurisdiction. This is particularly relevant to an ATS, as one of the options available to an ATS is to operate as a member of a recognized exchange.

*Part 3.* Section 3.1 requires an applicant for recognition as an exchange to file Form 21-101F1. Section 3.2 requires an applicant for recognition as an exchange and a recognized exchange to file an amendment to Form 21-101F1 within the time period specified in that section upon the occurrence of a change in the information on that form or an amendment to that form.

*Part 4.* Section 4.1 requires an applicant for recognition as a quotation and trade reporting system to file Form 21-101F1. Section 4.2 requires an applicant for recognition as a quotation and trade reporting system or a recognized quotation and trade reporting system to file an amendment to Form 21-101F1 within the time period specified in that section upon the occurrence of a change in the information on that form or an amendment to that form.

*Part 5.* Part 5 contains requirements applicable only to recognized exchanges and recognized quotation and trade reporting systems. Section 5.1 requires a recognized exchange and recognized quotation and trade reporting system to establish written standards for granting access to trading, to not unreasonably prohibit or limit access to services offered by it and to keep records of grants of access and denials or limitations of access. Section 5.2 provides that a recognized exchange or recognized quotation and trade reporting system shall not prohibit, condition, or otherwise limit, directly or indirectly, a member or user from effecting a transaction on an ATS. Section 5.3 requires a recognized exchange and recognized quotation and trade reporting system to adopt regulatory instruments that are not contrary to the public interest and are designed to accomplish certain objectives, including ensuring compliance with securities legislation, preventing fraud, promoting just and equitable principles of trade and fostering cooperation and coordination with persons or companies facilitating transactions in securities. Section 5.3 also requires a recognized exchange and recognized quotation and trade reporting system not to permit unreasonable discrimination between customers, issuers and members or users, and not to impose any burden on competition not necessary or appropriate in furtherance of securities legislation. Section 5.4 requires a recognized exchange and recognized quotation and trade reporting system to have regulatory instruments that provide that members and users shall be appropriately disciplined for violations of securities legislation and the regulatory instruments of the exchange or quotation and trade reporting system. Section 5.5 requires a recognized exchange and recognized quotation and trade reporting system to file with each securities regulatory authority that recognized it all regulatory instruments, and amendments to those instruments adopted by the exchange or quotation and trade reporting system. Section 5.6 requires a recognized exchange and recognized quotation and trade reporting system to prepare and file annual audited financial statements. The statements must be prepared in accordance with Canadian GAAP or, in the case of an entity incorporated in a foreign jurisdiction, reconciled with Canadian GAAP.

*Part 6.* Part 6 contains requirements applicable only to ATSs. Section 6.1 provides that an ATS shall not carry on business unless it is registered as a dealer and it is a member of a self-regulatory entity. Currently the Investment Dealers Association of Canada is the only entity that meets the criteria of self-regulatory



entity. Section 6.2 sets out the reporting requirements of an ATS, including the requirement to file an initial operation report, an amendment to that report, and a report on operations. Section 6.3 sets out the filings that an ATS is required to make when it wishes to cease carrying on business. Section 6.4 requires an ATS to give the securities regulatory authority six months notice before it begins to carry out certain activities such as listing securities, guaranteeing liquidity, adopting requirements governing the conduct of subscribers or establishing procedures for disciplining subscribers. These would all be activities that would take a person or company outside of the definition of ATS and would result in the securities regulatory authorities considering the person or company to be an exchange for purposes of securities legislation. Section 6.5 requires an ATS to provide notice to the securities regulatory authority if, during at least three of the preceding four calendar quarters, (i) trades on the ATS in any type of ATS security are equal to or greater than 40 percent of the average daily dollar value of the trading volume in that type of security on all marketplaces on which the type of ATS security trades, or (ii) trades on the ATS in a specific ATS security are equal to or greater than 50 percent of the average daily dollar value of the trading volume in that security on all marketplaces on which the ATS security trades and in any type of ATS security are equal to or greater than five percent of the average daily dollar value of the trading volume in that type of security on all marketplaces on which the type of ATS security trade. Section 6.6 prohibits a securityholder of an ATS and an affiliated entity of that securityholder from buying or selling securities on the ATS for their own account. Section 6.7 prohibits an ATS from releasing a subscriber's trading information to a person or company other than the subscriber and requires an ATS to implement reasonable safeguards and procedures to protect a subscriber's trading information. Section 6.8 prohibits an ATS from using in its name the word "exchange", the words "stock market", or any derivations of those terms.

*Part 7.* Part 7 of the proposed Instrument contains information transparency requirements for marketplaces. Section 7.1 requires a marketplace that displays orders to a person or company, other than its own employees or agents retained by it to assist in the operation of the marketplace, to provide to the data consolidator information regarding the total disclosed volume at each of the five best bid price and ask price levels for each security traded on the marketplace. Section 7.2 requires a marketplace to provide to the data consolidator accurate and timely information regarding details of all trades executed on the marketplace. Section 7.3 requires the data consolidator to produce a consolidated feed showing the information provided to the data consolidator under section 7.1 and 7.2 and the identity of the marketplace on which each trade takes place.

*Part 8.* Part 8 contains the market integration provisions of the proposed Instrument. Subsection 8.1(1) requires a marketplace that displays orders to a person or company to comply with the requirements of the market integrator to provide for access to orders displayed through the data consolidator. Subsection 8.1(2) requires a marketplace when receiving an order from another marketplace to apply its own rules to the execution of that order. Subsection 8.1(3) requires a marketplace to provide to marketplace participants of any other marketplace access to the orders it displays to the data consolidator that is equivalent to the access that the marketplace provides to its own marketplace participants.

*Part 9.* Section 9.1 requires a marketplace that charges a transaction fee that is greater than \$0.005 per security purchased or sold to disclose that transaction fee in the ask price or bid price displayed by it.

*Part 10.* Part 10 contains the recordkeeping requirements for marketplaces. Section 10.1 requires a marketplace to keep such records as are necessary for the proper recording of its business. Section 10.2 also requires a marketplace to keep other records, including a record of all marketplace participants who have been granted access to trading in the marketplace and daily trading summaries for the marketplace. Section 10.3 requires a marketplace to keep for not less than seven years, the first two years in a readily accessible location, all records required to be made by it under sections 10.1 and 10.2, at least one copy of its standards for granting access to trading and records relevant to its decision to grant, deny or limit access, records made or received by it in the course of complying with the system's requirements set out in section 11.1 and all written notices provided by the marketplace to marketplace participants generally. Subsection 10.3(2) also requires a marketplace to keep all organizational

documents, copies of all forms filed under the Instrument and notices provided under the Instrument. Section 10.4 allows a marketplace to, generally, keep all records, documents and forms referred to in Part 10 by means of mechanical, electronic or other devices.

*Part 11.* Section 11.1 applies to a marketplace's systems that support order entry, order routing, execution, trade reporting and trade comparison. Section 11.1 requires an ATS subject to section 11.1, a recognized exchange and a recognized quotation and trade reporting system to make capacity estimates, conduct capacity stress tests of critical systems, develop certain procedures to review and keep current the development and testing methodology, and establish reasonable contingency and business continuity plans. All these requirements are necessary in order for marketplaces to process transactions in an accurate, timely and efficient manner and ensure that systems can continue to operate in the event of the occurrence of physical hazards or natural disasters. Section 11.1 also requires the marketplaces subject to that section to notify the securities regulatory authority of material systems failures and changes and, on an annual basis, perform an independent review of their controls for ensuring compliance with section 11.1. Section 11.1 only applies to an ATS if trades on the ATS in any type of ATS security during four of any six consecutive calendar months are greater than 20 percent of the average daily dollar value of the trading volume in that type of security on all marketplaces on which the type of ATS security trades.

*Part 12.* Section 12.1 provides for the granting of exemptions from the Instrument.

### **Summary of Companion Policy 21-101CP**

Companion Policy 21-101CP has 13 parts.

*Part 1.* Section 1.1 sets out the purpose of the Companion Policy, being to state the views of the Canadian securities regulatory authorities on various matters related to the proposed Instrument.

*Part 2.* Section 2.1 discusses the characteristics of a "marketplace", as defined in the proposed Instrument. Subsections 2.1(3) and (4) set out the views of the CSA on what it means to "bring together orders for securities and "to use established, non-discretionary methods under which the orders interact with each other". Subsection 2.1(5) describes systems that the CSA do not consider to be marketplaces for purposes of the Instrument.

*Part 3.* Part 3 contains a discussion of the characteristics of exchanges, quotation and trade reporting systems and ATSs. Subsections 3.1(2) and (3) discuss the characteristics that the CSA generally associate with an exchange. Subsection 3.1(6) contains an explanation as to why the CSA want an ATS to inform it when it reaches or exceeds the 40 percent volume threshold referred to in subsection 6.5(1) of the proposed Instrument. Subsection 3.1(7) provides guidance by the CSA as to what is meant by "type" of security as used in the volume threshold tests in the proposed Instrument. Section 3.2 sets out the definition of quotation and trade reporting system commonly found in securities legislation and provides that a person or company that carries on business as a vendor of market data would not normally be considered to be a quotation and trade reporting system. Subsection 3.1(2) provides that a person or company cannot carry on business as a quotation and trade reporting system unless it is recognized appropriately in the local jurisdiction or it is an ATS that is in compliance with the proposed Instrument. Section 3.3 provides certain guidance as to the operation of an ATS. Subsection 3.3(1) provides that a marketplace that requires listing agreements, has market makers or sets rules governing the conduct of subscribers or disciplines subscribers would be an exchange and would have to be recognized as such in order to carry on business. Subsection 3.3(2) provides that the CSA do not consider an ATS that is in compliance with subsection 7.1(3) of the proposed Trading Rules to be disciplining subscribers. Subsection 3.3(3) provides that a marketplace that would otherwise meet the definition of an ATS in the proposed Instrument may apply to the CSA for recognition as an exchange. Subsection 3.3(7) provides that at this time, the Investment Dealers Association of Canada is the only body that would come within the definition of self-regulatory

entity for purposes of the proposed Instrument. Subsection 3.3(8) clarifies that section 6.6 of the proposed Instrument, which prohibits a securityholder of an ATS and an affiliated entity of that securityholder from buying or selling securities on that ATS for their own account, does not prevent those persons or companies from trading on another marketplace either as agent or principal.

*Part 4.* Section 4.1 provides that in selecting the data consolidator and market integrator for purposes of the proposed Instrument, the members of the CSA will act together.

*Part 5.* Subsection 5.1(2) provides that in exercising their public interest power in deciding whether to recognize an exchange or quotation and trade reporting system, the Canadian securities regulatory authorities will look at a number of factors, including the manner in which the exchange or quotation and trade reporting system proposes to comply with the proposed Instrument, whether the exchange or quotation and trade reporting system has fair and meaningful representation on its governing body, whether the exchange or quotation and trade reporting system has sufficient financial resources for the proper performance of its functions and whether the regulatory instruments adopted by the exchange or quotation and trade reporting system ensure that its business is conducted in an orderly manner so as to afford protection to investors.

*Part 6.* Section 6.2 sets out the views of the CSA on the term "order" that is defined in section 1.1 of the proposed Instrument. It provides that the label put on a transaction is not determinative of whether the transaction constitutes an order, but instead what is determinative is what actually takes place between the buyer and seller.

*Part 7.* Section 7.1 provides guidance as to the forms filed by marketplaces. Subsection 7.1(1) provides that a marketplace must apply to the CSA if it wishes to keep the forms filed confidential. Subsection 7.1(2) provides guidance as to the proposed term "significant" in subsection 6.2(2) of the proposed Instrument and indicates that in the view of the CSA, a change to the operations of an ATS is significant if it includes any changes to the operating platform of an ATS, the types of securities traded or the types of subscribers. Subsection 7.1(4) explains that subsection 6.3(1) of the proposed Instrument applies to an ATS that voluntarily ceases to carry on business and subsection 6.3(2) applies to an ATS that involuntarily ceases to carry on business.

*Part 8.* Part 8 elaborates on requirements in Part 5 of the proposed Instrument that are only applicable to exchanges and quotation and trade reporting systems. Section 8.1 makes it clear that the access requirements in section 5.1 of the proposed Instrument do not restrict the authority of an exchange or quotation and trade reporting system to maintain reasonable standards for access. Section 8.2 makes it clear that section 5.4 of the proposed Instrument does not preclude enforcement action by any other person or company, including the Canadian securities regulatory authorities. Section 8.3 provides that the securities regulatory authority will determine which of the regulatory instruments filed by a recognized exchange and recognized quotation and trade reporting system it will review based on securities legislation and other factors.

*Part 9.* Section 9.1 provides guidance as to section 6.7 of the proposed Instrument. That section requires an ATS not to carry on business unless it has implemented reasonable safeguards and procedures to protect a subscriber's trading information. Section 9.1 sets out the CSA's views on what should be included within those safeguards and procedures.

*Part 10.* Section 10.1 indicates that the reference to "total disclosed volume" in subsection 7.1(1) of the proposed Instrument refers to the amount of orders that is displayed in the marketplace. Volumes that are not disclosed or that are "reserve" or hidden volumes are not required to be displayed. Subsection 10.1(2) makes it clear that the CSA expect that information required to be provided to the data consolidator under the proposed Instrument will be provided in real time or as close to real time as possible.

*Part 11.* Section 11.1 provides guidance as to the operation of subsection 8.1(2) of the proposed Instrument. That subsection requires a marketplace, when receiving an order from another marketplace, to apply its own rules to the execution of that order. Section 11.1 explains that subsection 8.1(2) of the proposed Instrument requires a marketplace that displays orders through the data consolidator to provide access to its passive booked orders. Section 11.2 provides that subsection 8.1(3) of the proposed Instrument requires a marketplace to be able to receive from or send orders to another marketplace to which it is linked. Subsection 11.1(2) provides examples of practices that the CSA would consider to be in breach of subsection 8.1(3) of the proposed Instrument.

*Part 12.* Section 12.1 makes it clear that the CSA can require a marketplace to deliver to them any of the records required to be kept by the marketplace under securities legislation, including the records required to be maintained under Part 10 of the proposed Instrument.

*Part 13.* Section 13.1 provides guidance as to the capacity, integrity and security system's requirements of section 11.1 of the proposed Instrument. Subsection 13.1(2) provides that the activities described in section 11.1 of the proposed Instrument must be carried out at least once a year and the CSA would require these activities to be carried out even more frequently if there is a change to the marketplace that is material either in terms of structure or volume of trading that necessitates more frequent review. Subsection 13.1(3) makes it clear that the independent review should be performed by competent, independent audit personnel following established audit procedures and standards. Subsection 13.1(4) clarifies that once an ATS becomes subject to section 11.1 of the proposed Instrument, it remains subject to that section even if thereafter, it no longer satisfies the volume tests in section 11.2 of the proposed Instrument unless it is successful in obtaining relief under the proposed Instrument.

## **Summary of Forms**

The CSA are adopting four forms with the proposed Instrument. Form 21-101F1 is a form required to be filed by an exchange and quotation and trade reporting system when applying for recognition as an exchange and quotation and trade reporting system. The form contains a number of exhibits relating to the exchange and quotation and trade reporting system and affiliated entities.

Form 21-101F2 is the form required to be filed by an ATS when beginning operations or when changes occur to the information on that form. It also contains certain exhibits that include information as to the classes of subscribers on the ATS, a list of the types of securities that the ATS trades or expects to trade, other persons involved in the operation of the ATS and certain information as to the manner of operation of the ATS, procedures governing entry of orders into the ATS, means of access to the ATS, and fees charged by the ATS.

Form 21-101F3 is the form that must be filed by an ATS within 30 days after the end of each calendar quarter in which it operates. That form contains information as to ATS securities traded by the ATS during that calendar quarter, including type of securities and dollar volume.

Form 21-101F4 is the form required to be filed by an ATS when it ceases operations. The ATS must indicate why the ATS is ceasing operations and whether it holds securities or monies for any subscribers and arrangements made to return those securities or monies.

## **Summary of Trading Rules**

The proposed Trading Rules Instrument has nine parts.

*Part 1.* Section 1.1 contains the definitions of terms and phrases used in the National Instrument that are

not defined in or interpreted under a definition instrument in force in the jurisdiction.

*Part 2.* Part 2 contains provisions designed to prevent manipulation or fraud. Subsection 2.1(1) prohibits a person or company from engaging in or participating in a transaction or series of transactions or method of trading relating to a trade in or acquisition of a security if the person or company knows, or ought reasonably to know, that the transaction or series of transactions or method of trading results in or contributes to a misleading appearance of trading activity in, or an artificial price for, a security or perpetrates a fraud on any person or company. In Alberta, British Columbia and Quebec, provisions of securities legislation relating to manipulation and fraud apply instead of subsection (1). Section 2.2 prohibits a person or company from engaging in or participating in any transaction or series of transactions or method of trading relating to a trade in or acquisition of a security in an attempt to create a misleading appearance of trading activity in or an artificial price for a security or perpetrate a fraud on any person or company. Subsection 2.3(1) prohibits a person or company that has sold a put option from placing an offer to purchase securities of the same class of securities as those underlying the option at a price higher than the last price at which the underlying security last traded, while the option remains unexercised. Subsection 2.3(2) contains a similar prohibition for a call option.

*Part 3.* Subsection 3.1(1) prohibits a short sale of a security through the facilities of a marketplace (a) below the price of which the last sale of a board lot was displayed by the market consolidator or, (b) at the price at which the last sale of board lot was displayed by the market consolidator unless the last sale price was higher than the previous sale price of a board lot. Subsection 3.1(2) contains certain exceptions to the prohibition in subsection 3.1(1).

*Part 4.* Subsection 4.1(1) prohibits a marketplace participant either as principal or agent, from front running, *ie.*, purchasing or selling securities of a particular class or a derivative of those securities on a marketplace with knowledge of an order for the purchase or sale of those securities or the potential purchase or sale of those securities, if that information has not been generally disclosed. Subsection 4.1(2) prohibits a marketplace participant from informing, other in the necessary course of business, another person or company of an order for the purchase or sale of securities or the potential purchase or sale of securities on a marketplace if that information has not been generally disclosed. Subsection 4.1(3) prohibits a marketplace participant from purchasing or selling securities of an issuer or derivative of those securities in advance of the general disclosure of a report prepared by a person or company relating to those securities or the issuer of those securities if the marketplace participant has knowledge of the report and the report can reasonably be expected to have an impact on the price of the security. A marketplace participant may not disclose, other than in the necessary course of business, the forthcoming disclosure of such a report. Section 4.2 prohibits trading on inside information with respect to an issuer whose securities trade on a marketplace in Canada, where the issuer is not incorporated under the laws of Canada or a jurisdiction and is not a reporting issuer. Section 4.2 also prohibits tipping with respect to a material fact or material change with respect to that issuer. Section 4.3 contains defences to the prohibitions in sections 4.1 and 4.2.

*Part 5.* Part 5 contains best execution rules. Subsection 5.1(1) requires a marketplace participant acting as agent for a customer to make reasonable efforts to ensure that the customer receives the best execution price on a purchase or sale of securities by the customer. Subsection 5.1(2) requires a marketplace participant acting as agent for a customer to not execute a transaction on a marketplace that could be filled at a better price on another marketplace displayed in the consolidated market display. Subsection 5.1(3) requires a marketplace participant to make reasonable efforts to use facilities providing information or ability to execute orders in order to satisfy subsection 5.1(1).

*Part 6.* Subsection 6.1(1) provides that a marketplace participant, whether acting as agent or principal, having offsetting orders to buy and sell the same security at the same price shall not execute the trade for any quantity at a price equal to the best bid or best offer displayed in the consolidated market display unless the marketplace participant first satisfies any bids or offers displayed in the consolidated market

display at or better than the execution price. Subsection 6.1(2) provides that a marketplace participant that receives an order to buy or sell 10,000 shares or less of a security traded on a marketplace may not execute a principal transaction for those securities unless the marketplace participant buys at a higher price or sells at a lower price than the best bid or best offer displayed in the consolidated market display.

*Part 7.* Subsection 7.1(1) requires a recognized exchange and recognized quotation and trade reporting system to set requirements that prohibit marketplace participants from engaging in any of the conduct prohibited under the proposed Trading Rules and requiring marketplace participants to act in accordance with the best execution rules in Part 5. Subsection 7.1(2) requires a recognized exchange and recognized quotation and trade reporting system to monitor and enforce compliance with proposed Trading Rules either directly if it has been approved to do so by the securities regulatory authority or through an approved agent. Subsection 7.1(3) requires an ATS to enter into an agreement with an approved agent to monitor and enforce compliance with the requirements of the proposed Trading Rules.

*Part 8.* Section 8.1 provides for the granting of an exemption from the proposed Trading Rules.

### **Summary of Proposed Companion Policy 23-101CP**

Proposed Companion Policy 23-101CP contains seven parts.

*Part 1.* Section 1.1 provides that the purpose of the proposed Companion Policy is to state the views of the CSA on various matters related to the proposed Trading Rules. Section 1.2 provides that as a general matter the Canadian securities regulatory authorities expect marketplace participants to transact business openly and fairly, and in accordance with just and equitable principles of trade.

*Part 2.* Subsection 2.1(1) indicates that subsection 2.1(1) of the proposed Trading Rules prohibits price manipulation and deceptive trading as this is detrimental to investors and the integrity of the markets. It explains generally what is meant by price manipulation and deceptive trading. Subsection 2.1(4) sets out instances where the Canadian securities regulatory authorities would consider activities of a person or company to result in or contribute to a misleading appearance of trading activity in or an artificial price for a security. Subsection 2.1(5) indicates that normal market stabilization activities would not be considered to be a breach of subsections 2.1(1) and (2) of the proposed Trading Rules. Subsection 2.1(7) provides that subsections 2.1(3) and (4) of the proposed Trading Rules refers to "capping and pegging".

*Part 3.* Subsection 3.1(1) indicates that subsection 3.1(1) of the proposed Trading Rules refers to what is known as a "zero-plus tick" rule.

*Part 4.* Subsection 4.1(1) indicates that subsection 4.1(1) of the proposed Trading Rules prohibit "front running". Subsection 4.1(2) indicates that subsection 4.1(2) of the proposed Trading Rules prohibit tipping. Subsection 4.1(3) indicates that section 4.2 of the proposed Trading Rules, which prohibits insider trading with respect to issuers whose securities trade on a marketplace in Canada if the issuer is incorporated outside of Canada or a jurisdiction, is necessary because an ATS may trade foreign securities. Subsection 4.1(4) elaborates on the "Chinese Wall" defence in section 4.3 of the proposed Trading Rules.

*Part 5.* Subsection 5.1(1) provides guidance as to the requirements in subsection 5.1(1) of the proposed Trading Rules to make reasonable efforts to ensure that the customer receives the best execution price. Subsection 5.1(1) provides that in making reasonable efforts, a marketplace participant should consider whether it would be appropriate in particular circumstances to look at markets outside of Canada. Subsection 5.1(2) explains the rationale of the trade-through provisions in subsection 5.1(2) of the proposed Trading Rules. Subsection 5.1(3) sets out the views of the Canadian securities regulatory authorities on price improvement.

*Part 6.* Subsection 6.1(1) provides that a cross, as described in subsection 6.1(1) of the proposed Trading Rules is considered to be an offsetting order to buy and sell entered by a marketplace participant as principal or agent in any marketplace. Subsection 6.1(2) sets out the views of the Canadian securities regulatory authorities as to principal transactions.

*Part 7.* Section 7.1 provides that for the purposes of subsection 7.1(2) of the proposed Trading Rules, at this time, all exchanges in Canada have been approved for monitoring and enforcement compliance purposes.