

Chapter 13

SRO Notices and Disciplinary Proceedings

13.1.1 RS Notice – Commission Approval of RS Proposal – Allocation of Costs – First Group

May 9, 2008

No. 2008-005

MARKET REGULATION SERVICES INC.

NOTICE OF COMMISSION APPROVAL OF RS PROPOSAL

ALLOCATION OF COSTS – FIRST GROUP

Summary

This RS Notice provides notice of the approval by the applicable securities regulatory authorities effective April 15, 2008 of an allocation model for a series of direct charges to marketplaces to recover operational and capital costs caused by the introduction of new marketplaces.

RS will implement the proposed allocation of these charges immediately.

Questions / Further Information

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APPROVAL OF ALLOCATION OF COSTS – FIRST GROUP

Summary

This RS Notice provides notice of the approval by the applicable securities regulatory authorities (the “Recognizing Regulators”) effective April 15, 2008 of an allocation model (the “**Allocation Model**”) for a series of direct charges to marketplaces (the “**Marketplace Charges**”) to recover operational and capital costs caused by the introduction of new marketplaces.

This model relates to the first group of a number of pending charges and proposals relating to RS costs and fees.

The Marketplace Charges relate to the following:

1. RS’s internal administrative start-up costs associated with the launch of each new marketplace (“**Start-Up Costs**”);
2. the cost of the work performed by RS’s technology provider to allow RS’s systems to receive each new marketplace’s data through the existing firewall and to validate connectivity (“**Connection Costs**”);
3. the cost of the work performed by RS’s technology provider as a result of unique features of each new marketplace (if applicable) that require additional changes to RS’s systems (“**Marketplace-Specific Costs**”); and
4. the cost of modifying RS’s existing systems to receive data from all of those marketplaces for which RS cannot currently perform automated monitoring (“**Phase 1 Costs**”).

Based upon the public comments received and comments from the Recognizing Regulators, RS has modified the original allocation proposal (published for comment by RS in RS Notice 2006-007 – *Proposed Allocation of Costs – First Group* (November 17, 2006)) relating to Start-Up Costs and Phase 1 Costs as follows:

- **Start-Up Costs:** RS originally proposed to recover from each marketplace the greater of \$50,000 and RS's actual costs, based on time tracking by RS staff, associated with the launch of that marketplace. RS has modified this proposal so that RS will now recover from each marketplace RS's actual costs, whether greater than or less than \$50,000.
- **Phase 1 Costs:** RS originally proposed to recover Phase 1 Costs from the marketplaces for which RS is providing dedicated surveillance but cannot currently perform automated monitoring (i.e., all marketplaces other than Bloomberg Tradebook, the TSX and TSXV), with each contributing marketplace sharing the Phase 1 Costs equally. RS has modified this proposal so that RS will now recover the Phase 1 Costs from all marketplaces for which RS is the regulation services provider that are in operation on the date of approval, including Bloomberg Tradebook, the TSX and TSXV.

There are no other changes to the proposal as published in RS Notice 2006-007.

A summary of the comments received and RS's responses is available on the RS website.

The approved model for Start-Up Costs will be implemented for all new marketplaces that had not yet paid the fixed start-up fee on the date of RS Board approval of the modified proposal. RS will issue invoices to the relevant marketplaces for Connection Costs, Marketplace-Specific Costs and Phase 1 Costs incurred to date as soon as possible following approval. As was noted in RS Notice 2006-007, RS has already paid its technology provider for the Connection Costs and Marketplace-Specific Costs for certain marketplaces and Phase 1 Costs, and will be invoiced for the remaining Connection Costs and Marketplace-Specific Costs as they are incurred, and so needs to recover these amounts as soon as possible to minimize the interest and other carrying costs that will otherwise have to be recovered through UMIR regulation fees.

RS published a proposed UMIR regulation fee model for public comment in RS Notice 2007-001 – *Proposed UMIR Regulation Fee Model* (January 12, 2007). The Recognizing Regulators are continuing their review of that proposal.

RS will be developing further proposals in relation to the costs to consolidate marketplace data and develop displays and tools to provide effective cross-market monitoring. Such proposals are still subject to RS Board review and approval, as well as regulatory approval, and so will be published separately.

Background to the Allocation Model

Current RS Fee Model

RS currently recovers its operating and capital costs of providing UMIR regulation services through fees charged to marketplaces (in some cases, RS bills a marketplace's participating organizations or members directly), with the sole exception of Start-Up Costs, which RS collects directly from each marketplace.

In connection with the actual and anticipated introduction of new marketplaces, RS has incurred and will continue to incur one-time extraordinary costs to modify its technology systems to support RS's provision of regulation services to all marketplaces. In connection with approving these costs, the RS Board also considered the most appropriate allocation of these costs among the marketplaces for which RS provides regulation services, and appropriate payment arrangements.

Section 2 of Schedule A to RS's recognition order requires RS to charge fees on a cost recovery basis, to have a fair, transparent and appropriate process for setting fees, and to allocate those fees on an equitable basis among marketplaces and marketplace participants. The recognition order also provides that RS's fees will balance the need for RS Inc. to satisfy its responsibilities without creating barriers to access. The RS Board has observed each of these directives in approving the Allocation Model.

RS Review of Fee Model and Costs Associated with New Marketplaces

Beginning in April of 2006, the RS Board and Finance and Audit Committee undertook a detailed review of RS's fee model, as it relates to ongoing UMIR regulation fees and to one-time capital expenditures like those required in connection with the introduction of new marketplaces.

To assist with this review, RS engaged consultants from PricewaterhouseCoopers LLP, who performed a detailed analysis of RS's existing fee model and cost structure, and provided analysis and recommendations for a new fee structure that would best allow RS to charge fees on a cost recovery basis in accordance with its recognition order and other requirements set out in RS's regulation services agreements.

The Board and Finance and Audit Committee engaged in extensive analysis of the issues associated with ongoing UMIR regulation costs and capital expenditures, bringing to bear the expertise of their members as well as of PricewaterhouseCoopers

LLP and RS management and staff. The development of a fee model unavoidably requires trade-offs and compromises. RS believes that the Allocation Model represents the best possible balancing of the competing interests of RS's many stakeholder groups. It is the result of a comprehensive process of analysis and deliberation by RS's Directors.

RS also considered the allocation models used in other regulated industries (including telecommunications and electricity), which provide support for the principle that new entrants to a market must bear an equitable share of the costs of their entry.

RS also considered the U.S. experience with technology and cost-sharing relating to cross-market monitoring; Appendix "A" provides an overview of how similar issues were addressed in the U.S., and demonstrates that inter-market surveillance is conducted through coordination arrangements among multiple self-regulatory organizations. There are conflicting views as to the efficacy of these coordination arrangements, compared to the potential benefits of consolidated monitoring. Because monitoring activity is conducted separately by the NASD and NYSE, U.S. regulators have not had to address the allocation issues that RS has considered. The costs of coordinating monitoring activity (e.g., through the Intermarket Surveillance Group) in the U.S. are shared among the participating U.S. self-regulatory organizations.

Details of and Rationale for Allocation Model

Start-Up Costs

Start-Up Costs reflect RS's costs for the internal legal and operational work required in connection with the launch of a new marketplace, including:

- preparation of regulation services agreement;
- review of trading model and consultation on UMIR issues;
- development of procedural manuals; and
- training.

To date, RS has charged a fixed fee of \$25,000 to each marketplace to recover these costs. RS engaged in detailed tracking of the actual hours spent by RS staff in connection with recent marketplace launches. Based on charge rates for RS staff time, the average cost of start-up activities exceeds \$25,000.

It is therefore clear that the current fixed charge does not accurately reflect RS's costs associated with the launch of a new marketplace, and therefore creates a subsidy from existing marketplaces to each new marketplace to the extent that RS's costs in excess of the fixed amount are recovered through UMIR regulation fees.

RS originally proposed to recover from each marketplace the greater of \$50,000 and RS's actual costs, based on time tracking by RS staff, associated with the launch of that marketplace. RS has modified this proposal so that RS will now recover from each marketplace RS's actual costs, whether greater than or less than \$50,000.

RS believes that it is appropriate for each new marketplace to bear its Start-Up Costs directly, since these costs are directly caused by the introduction of the new marketplace and should therefore be recovered directly from that marketplace. RS also believes that this direct charge to the marketplace that allows RS to fully recover its internal costs creates a more appropriate incentive for the marketplace to participate in an efficient and timely process to finalize the regulation services agreement and other arrangements associated with the marketplace's launch. If these costs were shared by all marketplaces (as they would be if recovered through UMIR regulation fees), there would be no incentive for a new marketplace to work towards a timely and efficient resolution of issues associated with its launch.

Connection Costs

For each new marketplace for which RS performs automated monitoring, RS's technology provider (TSX Inc., under the current Corporate Services Agreement between RS and TSX Inc.) must perform approximately twenty person days of work to connect, configure and test RS's systems to receive the individual marketplace's data through RS's existing firewall and other security systems. There are no economies of scale applicable to this work; it must be performed for each new marketplace.

Again, RS believes that it is appropriate for each new marketplace to bear its Connection Costs directly, since these costs are directly caused by the introduction of the new marketplace and should therefore be recovered directly from that marketplace.

Connection Costs currently are \$26,393 plus GST for each new marketplace. This amount represents the actual charge to RS from its technology provider (billed to RS on a "cost plus 15%" basis). If the charge to RS changes in the future, marketplaces paying Connection Costs at that time will pay the new amount.

Each marketplace will be invoiced for its Connection Costs at the time that RS is invoiced by its technology provider.

Marketplace-Specific Costs

In addition to Connection Costs, a new marketplace may have unique features that require RS's technology provider to perform additional work to make additional changes to RS's systems. For example, Marketplace-Specific Costs would arise where a marketplace had unique markers, or a unique trading session that required modifications to RS's systems to accommodate, or forecast a level or type of trading activity that would require RS to expand its technology infrastructure.

To date, only one marketplace has incurred Marketplace-Specific Costs. Additional Marketplace-Specific Costs will likely be identified in the course of the work to consolidate marketplace data and develop displays and tools to provide effective cross-market monitoring.

RS believes that it is appropriate for each new marketplace to bear its Marketplace-Specific Costs directly, since these costs are directly caused by the unique features of the new marketplace and should therefore be recovered directly from that marketplace.

The amount of Marketplace-Specific Costs for each marketplace will represent the actual charge to RS from its technology provider (billed to RS on a "cost plus" basis). Each marketplace will be invoiced for its Marketplace-Specific Costs at the time that RS is invoiced by its technology provider.

Phase 1 Costs

In order to effectively monitor all marketplaces that RS regulates on an automated, real-time basis, RS must:

- receive data feeds from each of the marketplaces, using common feed standards; and
- consolidate marketplace data and develop displays and tools to provide effective cross-market monitoring.

RS refers to the first stage as "Phase 1" and the second stage as "Phase 2".

The need for RS to receive automated real-time feeds from different marketplaces, and to consolidate those feeds to enable cross-market monitoring, did not arise when RS was created in 2002 because the only marketplaces to be regulated were TSX and TSXV, and RS could monitor trading on these marketplaces using existing tools acquired from those marketplaces. Recent developments have created the need for RS to address these issues:

- With respect to automated monitoring, Shorcan ATS launched in August 2006 (but has since ceased operations), CNQ's Pure Trading facility launched in October 2006, MATCH Now (TriAct Canada) launched in July 2007, and Omega ATS launched in December 2007. Other marketplaces, including Chi-X Canada and Alpha Trading System, have announced plans to launch.
- With respect to cross-market monitoring, in 2005 BlockBook began trading TSX-listed securities, and securities were interlisted between TSXV and CNQ. In addition, MATCH Now, Pure Trading and Omega ATS trade TSX-listed securities.

Phase 1 delivers the various marketplaces' data to RS and stores that data in RS's systems. This will enable RS to review and access information on a post-trade basis without having to rely on a marketplace itself. Some of RS's current real-time alerts will work but, since the data from the various marketplaces will not be consolidated, RS will not have cross-market monitoring available. Additionally, it is possible that some alerts may actually need to be turned off for specific marketplaces as they will generate false positives.

The IT assets created by Phase 1 and Phase 2 will be "common" assets in the sense that they will allow RS to use its tools to monitor any marketplace that provides a data feed conforming to the RS feed standard. To the extent that a marketplace requires RS to have marketplace-specific "dedicated" IT assets necessary to monitor trading specifically on that marketplace, the marketplace will pay the entire cost for RS to develop those assets as Marketplace-Specific Costs.

RS's technology provider completed Phase 1 in July 2006. The cost to RS of Phase 1 was, by mutual agreement between RS and its technology provider, capped at \$300,000, comprising \$40,000 for requirements gathering and \$260,000 for development.

RS management and the RS Board engaged in detailed and extensive deliberations regarding the appropriate allocation of Phase 1 Costs among the marketplaces. Considerations included:

- the marketplaces that would receive a benefit from Phase 1;

- the extent to which the chosen allocation of Phase 1 Costs represents an equitable allocation among marketplaces;
- the extent to which a particular allocation was neutral among marketplaces;
- the extent to which imposing Phase 1 Costs on new marketplaces could represent a barrier to entry (which RS interpreted as imposing costs on a marketplace that exceed the cost of available alternatives); and
- the extent to which an inappropriate allocation of Phase 1 Costs could create the risk of “inefficient entry” (i.e., in which the costs of entry are held artificially low by a subsidy from other marketplaces).

RS originally proposed to recover Phase 1 Costs from the marketplaces for which RS is providing dedicated surveillance but cannot currently perform automated monitoring (i.e., all marketplaces other than Bloomberg Tradebook, the TSX and TSXV), with each contributing marketplace sharing the Phase 1 Costs equally. RS has modified this proposal so that RS will now recover the Phase 1 Costs from all marketplaces for which RS is the regulation services provider that are in operation on the date of approval, including Bloomberg Tradebook, the TSX and TSXV.

RS believes that equal sharing of Phase 1 Costs is appropriate, as opposed to sharing according to a formula based on trading activity or some other indicator, because the Phase 1 Costs are independent of expected trading volumes on any particular marketplace and the combined trading volumes of the marketplaces that will benefit from Phase 1.

RS also believes that the marketplaces that will pay the Phase 1 Costs should all pay an equal share, even though some of those marketplaces will not be monitored using the new technology until Phase 2 is completed. While Phase 1 has been completed, RS still cannot receive data feeds from certain marketplaces until Phase 2 is completed, because those marketplaces have unique features that must be addressed in Phase 2. Nevertheless, RS believes that these marketplaces should share in the Phase 1 Costs now, because Phase 1 is a necessary precondition to completing Phase 2.

Also, even though Phase 1 results in RS being able to receive a data feed from a marketplace that is required for automated monitoring, RS has the option to continue to perform manual monitoring of marketplaces where activity levels are low or RS otherwise considers it advisable. RS intends to continue to elect to perform manual monitoring of several marketplaces that could be monitored on an automated basis even though Phase 1 has been completed. (These marketplaces will not have to pay the Connection Costs until RS begins automated monitoring.) Nevertheless, RS believes that these marketplaces should also share in the Phase 1 Costs now, also because Phase 1 is a necessary precondition to completing Phase 2, and RS will require all marketplaces to move to automated monitoring once Phase 2 is completed so that RS can perform effective automated cross-market monitoring.

The total Phase 1 Costs of \$300,000 will be divided evenly among the number of marketplaces that will pay the Phase 1 Costs. These marketplaces will be the marketplaces in operation on the date that the Recognizing Regulators approve the Allocation Model. Ten marketplaces will therefore share the Phase 1 Costs, resulting in a cost-per-marketplace of \$30,000.¹ Each marketplace sharing in Phase 1 Costs will be invoiced immediately after RS receives regulatory approval for the Allocation Model as it relates to Phase 1 Costs.

If a new marketplace, not included in the original paying group, launches prior to the third anniversary of the date of Recognizing Regulator approval, the total Phase 1 Costs of \$300,000 would be re-divided among the new number of marketplaces and the new marketplace would pay its share in the manner described above. RS would divide the payment it receives from the new marketplace evenly among the existing marketplaces paying Phase 1 Costs and issue a refund to those marketplaces. For example, if nine marketplaces share the Phase 1 Costs and pay \$33,333 each, and a new marketplace launches within three years, the new marketplace will pay \$30,000 (equal to \$300,000 divided by ten), and each of the nine marketplaces that contributed to Phase 1 Costs will receive a refund of \$3,333. RS may also require a new marketplace that launches after the third anniversary of Recognizing Regulator approval to bear an equitable portion of the Phase 1 Costs.

Aggregate Impact on Marketplaces

Appendix “B” sets out the total payments to be made by each of the marketplaces currently in operation under the Allocation Model. The amounts in Appendix “B” do not include any amounts that the marketplaces may have to pay as their share of Phase 2 Costs (see “Further Proposals re Fee Model”, below).

RS believes that the total amounts to be paid by individual marketplaces do not represent a barrier to entry and are reasonable since they are significantly lower than the costs that these marketplaces would incur – each individually or together – to duplicate the existing technology in place at RS and that RS will use to monitor trading on those marketplaces. The new

¹ That is, \$300,000 divided ten ways among TSX, TSXV, CNQ, Pure Trading, Bloomberg Tradebook, BlockBook, Liquidnet, MATCH Now, Omega ATS and Chi-X Canada.

marketplaces that are sharing in the Phase 1 Costs are benefiting from the considerable economies of scale and scope provided by RS's existing technology infrastructure. As noted below, RS may propose that these marketplaces share in Phase 2 Costs if those costs are approved by the RS Board and depending on the allocation model approved by the Board. RS has considered the impact of the aggregate cost, including potential Phase 2 Costs, and believes that the total costs to each marketplace would not represent a barrier to entry.

Further Proposals re Fee Model

RS published a proposed UMIR regulation fee model for public comment in RS Notice 2007-001 – *Proposed UMIR Regulation Fee Model* (January 12, 2007). The Recognizing Regulators are continuing their review of that proposal.

RS will be developing a further proposal in relation to the costs to consolidate marketplace data and develop displays and tools to provide effective cross-market monitoring (referred to above as "Phase 2"). The approved allocation of Phase 1 Costs is in no way determinative of the allocation of Phase 2 Costs. The allocation of Phase 2 Costs is subject to RS Board review and approval, as well as regulatory approval, and so will be published separately. Note that RS may propose that the marketplaces listed in Appendix "B" share in Phase 2 Costs, which will be in addition to those costs set out in Appendix "B".

RS believes that the Allocation Model is consistent with the goal of a fair and transparent fee structure for the self-regulatory organization to be formed by the merger of RS and the IDA, and intends to carry this model forward into the new organization.

Status and Timetable

The approved model for Start-Up Costs will be implemented for all new marketplaces that had not yet paid the fixed start-up fee on the date of RS Board approval of the modified proposal. RS will issue invoices to the relevant marketplaces for Connection Costs, Marketplace-Specific Costs and Phase 1 Costs incurred to date as soon as possible following approval. As was noted in RS Notice 2006-007, RS has already paid its technology provider for the Connection Costs and Marketplace-Specific Costs for certain marketplaces and Phase 1 Costs, and will be invoiced for the remaining Connection Costs and Marketplace-Specific Costs as they are incurred, and so needs to recover these amounts as soon as possible to minimize the interest and other carrying costs that will otherwise have to be recovered through UMIR regulation fees.

Questions / Further Information

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Appendix A
Cross-Market Monitoring in the United States

Intermarket Monitoring Arrangements in the U.S.

Overview

Each SRO (i.e., NASD, Nasdaq, NYSE and the other national securities exchanges in the U.S.) is required to have rules designed, among other things, to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and to refrain from imposing any unnecessary or inappropriate burdens on competition. For example, an SRO must maintain procedures to surveil against rule violations, including insider trading and market manipulation. While different market structures may imply different procedures for accomplishing this task, SROs are required to expend sufficient resources, in terms of both staff and technology, to support their surveillance functions. This includes having officers with expertise in monitoring for compliance with federal securities laws and SRO rules, and an understanding of the role of a registered exchange or association as an SRO. An SRO must deploy adequate examination and surveillance systems and maintain an audit trail of the transactions in its system. SROs' regulatory programs are periodically inspected by the SEC.

The NASD and the NYSE maintain central audit trail systems for trading in Nasdaq and NYSE securities, respectively. The NASD system is called OATS (Order Audit Trail System) and the NYSE system is called OTS (Order Tracking System). NASD and NYSE members are required to provide order data to the regulator through these systems. These systems are then used in the market surveillance conducted by the NASD and NYSE for their respective securities.

Nasdaq and NYSE securities are traded on numerous other U.S. markets through unlisted trading privileges. The U.S. markets created the Intermarket Surveillance Group (ISG) to coordinate their monitoring of trading across markets. ISG has established information sharing arrangements that provide for the exchange of market data surveillance information among the SROs through various means. Generally, information is shared between the members on an as-needed basis and only upon request.

The U.S. members of ISG share trading information, including audit trail information, on a formalized basis electronically via the facilities of the Securities Industry Automation Corporation (SIAC). For example, the ISG makes its Consolidated Equity Audit Trail available through the SIAC. The ISG also has a Consolidated Options Audit Trail System. These systems are intended to supplement the surveillance systems of individual markets.

ISG has developed and implemented investigative practices for coordinated investigations. ISG's general meetings held three times each year, as well as frequent meetings of the Surveillance Practices, Surveillance Investigative Practices, Technology, and Option sub-groups, are intended to develop uniform definitions of intermarket abuses and provide a forum for coordinating joint surveillance efforts.

Recent Developments

In 2003, Nasdaq filed a petition with the SEC that contained numerous complaints about these arrangements, including the following claims:

- investors are potentially harmed by the lack of uniform trading rules and from unequal surveillance and enforcement of rules by the various SROs;
- no other market currently executing trades in Nasdaq-listed securities has rules requiring its members to report order audit trail information or operates a Commission-approved order audit trail;
- for transactions reported away from Nasdaq, the ISG/SIAC audit trail has the following deficiencies:
 - it only provides trade information at the clearing firm level, as opposed to both the clearing firm and the executing firm levels;
 - the time fields in the data are not generated by clocks subject to uniform synchronization protocols, as is the case with OATS data;
 - ISG/SIAC data is not provided in a format that is conducive to integration into NASD's automated surveillance systems – as a result, manually processing this information can be time-intensive;
 - ISG/SIAC data is not received until two days after the trade date; Nasdaq claimed that such a delay can significantly hinder NASD's ability to investigate unlawful trading activity on a real-time basis and can prevent NASD from obtaining non-stale regulatory information in an ongoing investigation;

- consolidated regulation protects investors better than the coordinated regulation that ISG/SIAC facilitates;
- consolidated regulation should be crafted by the entities that will be governed, whereas ISG is a voluntary organization whose membership includes SROs (only some of which trade Nasdaq-listed securities) and certain foreign entities that are not regulated as SROs by the SEC; and
- in the absence of a framework for adopting uniform order audit trails and uniform enforcement of marketplace rules, Nasdaq is forced to subsidize other markets' regulatory costs; Nasdaq funds NASD's OATS to collect trading information from all NASD members, whether or not the trades are reported to Nasdaq.

These issues have not been resolved. In the *Concept Release Concerning Self-Regulation* issued in November 2004, the SEC again solicited comment on intermarket monitoring arrangements among the various SROs. The SEC summarized the comments received on Nasdaq's 2003 petition as follows:

- some commenters argued that existing audit trail systems were well-designed, even though they did not interact with Nasdaq's;
- many commenters were concerned that complying with multiple SROs' different order audit trail systems would be burdensome and expensive to implement and administer;
- other commenters argued that Nasdaq had understated the effectiveness of ISG and that the organization should be allowed to continue in its role as the facilitator of regulatory data sharing among markets;
- the ISG stated that
 - the SROs are able to view trading activity in the context of all markets' clearing level quote and trade data;
 - its Equity Audit Trail system provides a consolidated view across all markets of quotes and trades, including clearing information;
 - no other market had raised the issues that Nasdaq raised in its petition; and
 - neither the time delays in receiving information through ISG nor the lack of a uniform synchronization protocol had proven to be problematic;
- the NYSE generally supported the traditional role of the ISG, and raised the possibility of the SEC requiring that each individual market establish an order audit trail system similar to the NYSE's and the NASD's and mandating that the data from these separate order audit trails be integrated into the ISG's consolidated order audit trail; and
- the NASD argued that the current model of coordinated regulation results in regulatory gaps and that potential misconduct can occur across markets undetected by regulators, and that the less detailed regulatory information collected by the ISG/SIAC lacks certain critical pieces of information to effectively assist SROs in regulating intermarket trading activity.

In the SRO Concept Release, the SEC asked for responses to the following questions:

- To what extent does our market model of multiple competing SROs create gaps in intermarket trading surveillance? What types of illicit trading activity in particular can be hidden from regulators by dispersing trading across multiple markets?
- How effectively does the ISG serve as a facilitator of regulatory data sharing and surveillance coordination among SROs? Is the ISG's order audit trail effective as a regulatory tool? How feasible would it be to require all markets to adopt order audit trails similar to those of the NYSE and the NASD and ultimately to integrate all markets' order audit trails into the ISG's consolidated order audit trail?
- How similar are the order audit trail systems of the NYSE and the NASD? Could they be merged into one consolidated system and what would be the benefits of such a consolidated system? Should NASD's OATS or NYSE's OTS requirements be extended to all equity markets to enhance the ability of SROs to surveil intermarket activity? If so, could all markets' individual order audit trails be successfully integrated into the ISG's consolidated order audit trail or another consolidated system? How useful a regulatory tool would the

ISG's consolidated order audit trail system be if all markets were required to adopt their own order audit trail systems and their data was required to be integrated into the ISG's?

- To what extent is there a need for an order audit trail to provide crossover surveillance between the equities and options markets? To what extent would such crossover surveillance detect specific types of illicit trading activity?

There has been no further SEC communication following the issuance of the SRO Concept Release that contained these questions.

It therefore appears clear that the interaction of SRO monitoring of separate markets is a work in progress in the U.S. and that there are significant outstanding issues relating to the effectiveness of inter-market surveillance.

Allocation of Costs of Intermarket Monitoring in the U.S.

The NASD agreed to create OATS in response to an SEC order issued in 1996 following the discovery of collusion among market makers and other misconduct on Nasdaq. The NASD also agreed to increase its staffing in the areas of examinations, surveillance, enforcement, and internal audit in response to that order. The offer of settlement from the NASD to SEC stated that the NASD had authorized US\$25 million and committed to expend an additional US\$75 million over the following five years to enhance its systems for market surveillance, including the development and implementation of OATS. Nasdaq funded the creation of the OATS system and, as Nasdaq's 2003 petition noted, funds the continued operation of OATS.

The NYSE implemented OTS in response to a separate SEC finding that the NYSE had failed to provide adequate supervision, in its case of independent floor brokers. We have not found any information indicating that the NYSE did not fund the development of OTS itself, or the cost of the system.

The costs involved with the development and maintenance of ISG surveillance tools and the operation of ISG with respect to U.S. intermarket monitoring are funded by the U.S. ISG members by mutual agreement.

Appendix B
Impact on Marketplaces of Allocation Model

Marketplace	Start-Up Costs¹	Connection Costs²	Marketplace-Specific Costs³	Phase 1 Costs⁴	Total
Group A (1 marketplace)	\$25,000	\$26,393	\$12,500	\$30,000	\$93,893
Group B (3 marketplaces)	\$25,000	\$26,393	-	\$30,000	\$81,393
Group C (6 marketplaces)	\$25,000	-	-	\$30,000	\$55,000

¹ This amount will increase to RS's actual Start-Up Costs.

² The amounts set out in the table reflect current Connection Costs. Actual Connection Costs may change in the future. Also, a marketplace will not be invoiced for Connection Costs until RS decides to commence automated monitoring of that marketplace.

³ To date, only one marketplace has incurred Marketplace-Specific Costs. Additional Marketplace-Specific Costs will likely be identified in the course of Phase 2.

⁴ Each marketplace's share of Phase 1 Costs will decrease if additional new marketplaces begin operations and contribute to Phase 1 Costs.