
Notices / News Releases 1999/12/24 — Notice of Proposed Criteria for Recognition in Connection with the TSE Demutualization — Request for Comments

Issue: December 24, 1999

Citation: 22 O.S.C.B. 8282

Introduction

The Toronto Stock Exchange (the “TSE” or the “Exchange”) is currently recognized as a stock exchange pursuant to section 21 of the Securities Act, R.S.O. 1990, c.S.5. The Ontario Securities Commission (the “Commission”) has requested that the Exchange submit to a re-recognition process in the context of its proposed demutualization by way of continuance under the Business Corporations Act (Ontario).

We are publishing for comment proposed criteria for recognition together with possible terms and conditions of recognition. At this time, we are also publishing commentary prepared by the TSE concerning its positions regarding the recognition criteria.

Background

On June 10, 1999, the members of the Exchange approved a by-law authorizing the Exchange to continue as The Toronto Stock Exchange Inc. (“TSE Inc.”) under the Ontario Business Corporations Act (“OBCA”). The effect of the continuance would be that:

- The Exchange would become a for-profit corporation;
- The Exchange would be owned by shareholders instead of member firms based on holding a seat. Members will exchange their seats for shares and will initially be the shareholders of TSE Inc.;
- Share ownership would be limited to 5% of outstanding shares unless the prior consent of the Commission is obtained;
- Members will be “grandfathered” in terms of the number of shares they will be issued on exchanging their seats but will not be able to exercise more than 5% of the votes outstanding unless the prior consent of the Commission is obtained;
- Access to TSE Inc.'s trading system would be based on contract, not ownership. Existing members at the time of the continuance would be granted access as Participating Organizations and would not be required to be shareholders of TSE Inc. in order to trade;

On December 14, 1999, legislation amending the current *Toronto Stock Exchange Act* received Royal Assent. The amendments to the *Toronto Stock Exchange Act* provide for the continuance of the Exchange under the OBCA. The legislation also provides that the continuance must be

approved by the Commission and the Ontario Minister of Finance.

Framework for Demutualization

The following aspects must be considered in connection with the demutualization of the TSE:

1. Legislation providing for the continuance of the Exchange under the OBCA received Royal Assent on December 14, 1999;
2. Approval must be obtained from the Commission and the Ontario Minister of Finance;
3. A new Rule Book and Policies has been approved by the Board of Governors of the Exchange. Staff are in the process of reviewing the Rule Book and Policies which were published for comment in the OSC Bulletin on November 5, 1999;
4. Proposed criteria for recognition have been developed. The TSE has prepared commentary on its positions regarding the recognition criteria. Following the comment process, the Commission proposes to issue a new recognition order for TSE Inc.

A. — Amendments to legislation

The Exchange is currently incorporated under special purpose legislation of the Province of Ontario (the *Toronto Stock Exchange Act*). Amendments to the *Toronto Stock Exchange Act* permit the Exchange to be continued under the OBCA subject to the approval of the members of the Exchange, the Commission and the Minister of Finance. Complementary amendments are proposed to the *Securities Act* to provide that no person or company may beneficially own or control more than 5% of any class or series of voting shares of TSE Inc. without the prior approval of the Commission. These amendments received Royal Assent on December 14, 1999.

An earlier draft of the proposed legislation was published for comment in the OSC Bulletin on July 30, 1999. No comments were received.

B. — Proposed Rule Book and Policies of TSE Inc.

On October 26, 1999, the Board of Governors of the Exchange approved the proposed Rule Book and Policies of TSE Inc. (filed with the Commission on November 3, 1999). A Notice concerning the proposed Rule Book and Policies was published for comment in the OSC Bulletin on November 5, 1999. Implementation of the Rule Book and Policies is subject to approval by the Commission following public notice and comment. The Rule Book and Policies are to be effective concurrent with demutualization.

The current provisions of the General By-law of the Exchange and the policies, rulings and directions of the Board of Governors will be replaced with a Rule Book and Policies. The Rule Book and Policies contain a reorganization of existing provisions. The Exchange is of the view that, to the greatest extent possible, the Rule Book does not make any substantive change in the rules, though many of the rules have been significantly redrafted to simplify and clarify the language.

C. — Recognition criteria

Pursuant to the amendments to the *Toronto Stock Exchange Act*, the Commission must approve the continuance before it can become effective. As a condition of approving the continuance, the Commission has requested that the Exchange submit to a recognition process. Staff of the TSE and Staff of the Commission have been engaged in extensive discussions leading to the publication of the recognition criteria and the TSE's response to the recognition criteria.

The proposed recognition criteria address the following areas:

1. Corporate Governance
2. Fees
3. Access
4. Financial Viability
5. TSE Regulatory Services (“TSE RS”)
6. Capacity and Integrity of Systems
7. Purpose of Rules
8. Rules and Rule-Making
9. Financial Statements
10. Discipline of Participating Organizations
11. Due Process
12. Information Sharing
13. Listed Company Regulation
14. Additional Information

The Exchange must establish to the satisfaction of the Commission that criteria set out for each of the items identified above have been satisfied.

The Commission recognizes that the structure of the markets and strategic plans for the TSE are in a transitional phase due to the introduction of alternative trading systems and other competitive challenges to traditional exchanges. Therefore, it may be necessary for the TSE, upon its own initiative, or upon the request of the Commission, to reassess its governance structure, the operation of TSE RS and any other matters to deal with changes in the marketplace. TSE Staff have provided an undertaking to OSC Staff to reassess TSE RS's operations and structure 12 months from the effective date of demutualization and report back to the Commission.

Comments are sought on all aspects of the proposed criteria for recognition. Comments should be in writing and delivered on or before January 31, 2000 addressed to the attention of the Secretary to the Commission, Ontario Securities Commission, 20 Queen Street West, Toronto, Ontario, M5H 3S8.

After the comment period has ended, any comments concerning the recognition criteria will be considered. If the Commission is satisfied that the Exchange has met the criteria for recognition, the Commission will approve the continuance. Approval will be in the form of a Recognition Order with terms and conditions generally in the form of those attached to this notice.

Questions may be referred to:

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Proposed Criteria for Recognition of the Toronto Stock Exchange

1. — Corporate Governance

(a) The TSE's arrangements with respect to the appointment, removal from office and functions of the persons ultimately responsible for making or enforcing the rules of the TSE, namely, the governing body, are such as to ensure a proper balance between the interests of the different entities desiring access to the facilities of the TSE ("Participating Organizations"), and in recognition that the protection of the public interest is a primary goal of the TSE, a reasonable number and proportion of directors are independent of Participating Organizations in order to ensure diversity of representation on the Board.

(b) Without limiting the generality of the foregoing, the TSE's governance structure provides for:

(i) fair and meaningful representation on its governing body, in the context of the nature and structure of the TSE, and any governance committee thereto and in the approval of rules;

(ii) appropriate representation of persons independent of Participating Organizations on TSE committees and on any executive committee or similar body;

(iii) appropriate qualifications, remuneration, conflict of interest provisions and limitation of liability and indemnification protections for directors and officers and employees of the TSE generally;

Recognition Order Term and Condition: The TSE shall comply with paragraph 1 of the recognition criteria with respect to corporate governance for the Board, in particular, at least 50 per cent of its directors shall consist at any time of individuals who are unrelated to Participating Organizations.

2. — Fair and Appropriate Fees

(a) Any and all fees imposed by the TSE on its Participating Organizations are equitably allocated. Fees do not have the effect of creating barriers to access and must be balanced with the criteria that the TSE have sufficient revenues to satisfy its responsibilities.

(b) The TSE's process for setting fees is fair and appropriate.

Recognition Order Term and Condition: The TSE shall comply with paragraph 2 of the recognition criteria with respect to fees.

3. — Access

(a) The requirements of the TSE permit all properly registered dealers that are SRO members and satisfy the criteria to access the facilities of the TSE.

(b) Without limiting the generality of the foregoing, access requirements provide that the TSE:

(i) establish written standards for granting access to trading on it;

(ii) not unreasonably prohibit or limit access by a person or company to services offered by it; and

(iii) keep records of

(A) each grant of access including, for each entity granted access to the trading facilities, the reasons for granting such access, and

(B) each denial or limitation of access, including the reasons for denying or limiting access to any applicant.

Recognition Order Term and Condition: The TSE shall comply with paragraph 3 of the recognition criteria with respect to access.

4. — Financial Viability

The TSE has sufficient financial resources for the proper performance of its functions.

Recognition Order Term and Condition: The TSE shall comply with paragraph 4 of the recognition criteria with respect to financial viability and, in particular, shall file quarterly financial statements within 60 days of the quarter end and annual financial statements within 90 days of year-end. The TSE shall report to the Commission when (1) the liquidity test shows a deficiency between working capital and borrowing capacity over two years of net operating and capital investment requirements plus debt repayment; (2) the solvency ratio declines to a figure of 1.3:1 (assets: liabilities); or (3) the financial leverage ratio rises to 4.0 (assets: capital). If the TSE remains below any of the acceptable liquidity, solvency or financial leverage ratios for a period of more than three months, the CEO will deliver a letter advising the Commission of the reasons for the continued ratio deficiencies, the steps being taken to rectify the problem, and will not reduce the capital in any manner or make any loans, bonuses, dividends or other distribution of

assets to any director, officer, related company or shareholder until the deficiencies have been eliminated for at least six months. The TSE shall provide a report annually of the monthly calculation of the ratios, the appropriateness of the calculation of the ratios and whether any alternative calculations should be considered.

5. — TSE RS

The TSE will ensure that it maintains its ability to perform its self-regulatory functions including setting requirements governing the conduct of participants and disciplining participants.

Recognition Order Term and Condition:

1. The TSE shall provide the Commission with an annual report including a report on the operations of Regulatory Services and with such information regarding its affairs, including the affairs of Regulatory Services, as may be requested from time to time. The annual report shall be in such form as may be specified by the Commission from time to time.
2. The TSE shall not make any fundamental changes to the organizational structure of Regulatory Services or to the structure of the TSE that would materially affect Regulatory Services without prior Commission approval.
3. Regulatory Services shall promptly report to the Commission misconduct or apparent misconduct by Participating Organizations and their Approved Persons and others where investors, Participating Organizations or their customers, the CIPF or the TSE may reasonably be expected to suffer serious damage as a consequence thereof, including where the solvency of a Participating Organization is at risk, the TSE has a reasonable apprehension that serious fraud may be present or there may exist serious deficiencies in supervision or internal controls.
4.
 - (a) The public and media shall be notified by way of press release of any disciplinary or settlement hearing not less than 10 days prior to the date of any such hearing, and such information shall also be published in the Ontario Securities Commission Bulletin (unless the Commission determines otherwise). The public and the media shall be promptly notified by way of press release, and publication in the Ontario Securities Commission Bulletin of the disposition of all disciplinary actions (unless the Commission determines otherwise).
 - (b) Disciplinary and settlement hearings shall be open to the public and media except where required for the protection of confidential matters.
5. The Commission shall be notified on a monthly basis of (i) all new investigations initiated by Regulatory Services including the persons involved and the nature of the investigation and (ii) all investigations which do not lead to disciplinary proceedings and which are closed, including the date the investigation started, the conduct and persons involved and the disposition of the investigation.
6. Subject to any changes that may be agreed between the TSE and the Commission,

Regulatory Services will be operated on the following basis:

- (a) The functions of Regulatory Services shall be carried out with a view to operating on a cost-recovery basis and shall be independent and structurally separated from the for-profit operations of the TSE.
- (b) Regulatory Services shall be a separate division of the TSE which shall be governed by the Board of Directors of the TSE. The Board shall establish a special committee of the Board (the "Regulation Committee") to oversee the operations of Regulatory Services. The Regulation Committee shall consist of the President (if a Director) and such other Directors as the board may determine, provided that more than 50% of the members of the Regulation Committee shall consist of directors who are not associated with any Participating Organization within the meaning of the TSE's by-laws, rules or regulations. In addition to members of the Board, the Regulation Committee may also consist of members who are associated with a Participating Organization, including alternative trading systems which are Participating Organizations as well as any alternative trading system for which Regulation Services provides services.
- (c) The chief operating officer of Regulatory Services (referred to herein as the "COO") shall, while reporting to the TSE's President, generally be present wherever practicable at all meetings of the Regulation Committee and all meetings of the Board relating to the operations of Regulatory Services unless the Regulation Committee or the Board determines otherwise, and shall provide information upon request to the Regulation Committee or the Board with respect to the operations of Regulatory Services. The COO and the President shall both be responsible for ensuring that the operations of Regulatory Services are conducted appropriately.
- (d) Regulatory Services shall have a segregated budget, including for technological support and development, which budget shall be subject to the approval of the Board upon the advice of the Regulation Committee and shall be administered by the COO in consultation with the President. Regulatory Services shall also be allocated the necessary support from other departments of the TSE, including in the technology area, in accordance with its budgets and reasonable requirements.
- (e) The TSE shall adopt and use all reasonable efforts to comply with policies and procedures designed to ensure that confidential information concerning the operations of Regulatory Services is maintained in confidence and not shared inappropriately with the for-profit operations of the TSE or other persons.
- (f) The COO, the President, the Regulation Committee and the Board shall provide information with respect to the operations of Regulatory Services to the Commission upon request.
- (g) TSE shall maintain the ability of Regulatory Services to perform its market regulation functions and shall advise the Commission at least annually of its staff complement, by function, and of any material changes or reductions in Regulatory Services staff, by function.

(h) Management of the TSE (including the President and the COO) shall at least annually self-assess the performance by Regulatory Services of its market regulation functions and report thereon to the Regulation Committee, together with any recommendations for improvements. The Regulation Committee shall in turn report to the Board as to the performance by Regulatory Services of its market regulation functions. The TSE shall provide the Commission with copies or summaries of such reports and shall advise the Commission of any proposed actions arising therefrom.

(i) The TSE shall report to the Commission within 18 months of the operation of TSE RS on how it has fulfilled the terms and conditions regarding TSE RS.

6. — Capacity and Integrity of Systems

For each of its systems that support order entry, order routing, execution, trade reporting and trade comparison, capacity and integrity requirements provide that the TSE:

- (a) make reasonable current and future capacity estimates;
- (b) conduct capacity stress tests of critical systems on a reasonably frequent basis to determine the ability of those systems to process transactions in an accurate, timely and efficient manner;
- (c) develop and implement reasonable procedures to review and keep current the development and testing methodology of those systems;
- (d) review the vulnerability of those systems and data centre computer operations to internal and external threats including physical hazards, and natural disasters;
- (e) establish reasonable contingency and business continuity plans;
- (f) on an annual basis, perform an independent review, in accordance with established audit procedures and standards, of their controls for ensuring that each of them is in compliance with paragraphs (a) through (e), and conduct a review by senior management of a report containing the recommendations and conclusions of the independent review; and
- (g) promptly notify the securities regulatory authority of material systems failures and changes.

Recognition Order Term and Condition: The TSE shall comply with paragraph 6 of the recognition criteria with respect to systems capacity and integrity.

7. — Purpose of Rules

- (a) The by-laws, rules, regulations, policies, procedures, practices, interpretations and other similar instruments (the “Rules”) of the TSE are designed to:
- (i) ensure compliance with securities legislation;
 - (ii) prevent fraudulent and manipulative acts and practices;
 - (iii) promote just and equitable principles of trade; and

(iv) foster cooperation and coordination with persons or companies engaged in regulating, clearing settling, processing information with respect to, and facilitating transactions in, securities.

(b) The Rules of the TSE shall not:

(i) permit unreasonable discrimination between customers, issuers and Participating Organizations; or

(ii) impose any burden on competition that is not necessary to appropriate in furtherance of securities legislation

(c) The Rules of the TSE ensure that its business is conducted in an orderly manner so as to afford protection to investors.

Recognition Order Term and Condition: The TSE shall, subject to the terms and conditions of this recognition order and the jurisdiction and oversight of the commission in accordance with Ontario securities laws, through regulatory services and otherwise, establish such rules, regulations, policies, procedures, practices or other similar instruments as are necessary or appropriate to govern and regulate all aspects of its business and affairs and shall in so doing specifically govern and regulate so as to:

(a) seek to ensure compliance with securities legislation;

(b) seek to prevent fraudulent and manipulative acts and practices;

(c) seek to promote just and equitable principles of trade;

(d) seek to foster cooperation and coordination with persons or companies engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in, securities; and

(e) seek to provide for appropriate discipline.

8. — Rules and Rule-making

All by-laws, rules, regulations and policy statements of general application and amendments thereto, adopted by the Board must be filed with the Commission both in French and English. The details in respect of the approval of rule proposals are set out in a Memorandum of Understanding between the Commission and the TSE regarding the review and approval of by-laws, rules, regulations and policy statements and amendments dated October 23, 1997.

Recognition Order Term and Condition: The TSE, including Regulatory Services, shall comply with the existing protocol between the Toronto Stock Exchange and the Commission, as it may be amended from time to time, concerning Commission approval of changes in its rules and regulations.

9. — Financial Statements

The TSE shall prepare annual audited financial statements, in accordance with Canadian GAAP

and covered by a report prepared by an independent auditor.

The TSE shall file with the Commission the financial statements within 90 days after the end of its latest financial year.

Recognition Order Term and Condition: The TSE shall file annual and quarterly financial statements, with segmented reporting for TSE RS.

10. — Discipline of Participating Organizations

The TSE shall have the authority and the by-laws, rules, regulations or other similar instruments that provide that entities granted access to the facilities of the TSE shall be appropriately disciplined for violations of securities legislation and the by-laws, rules, regulations, policies, procedures, practices and other similar instruments of the TSE.

Recognition Order Term and Condition: The TSE shall appropriately discipline its participating organizations for violations of securities legislation and the by-laws, rules, regulations, policies, procedures, practices and other similar instruments of the TSE.

11. — Due Process

The requirements of the TSE relating to access to the facilities of the TSE, the imposition of limitations or conditions on access and denial of access are fair and reasonable, including in respect of notice, an opportunity to be heard or make representations, the keeping of a record, the giving of reasons and the provision for appeals.

Recognition Order Term and Condition: The TSE shall comply with paragraph 11 of the recognition criteria with respect to due process.

12. — Information Sharing

The TSE is able and willing to cooperate, by the sharing of information and otherwise, with the Commission and its staff, and other Canadian federal, provincial and territorial recognized self-regulatory organizations and regulatory authorities.

Recognition Order Term and Condition: The TSE, including Regulatory Services, shall co-operate by the sharing of information and otherwise, with the Commission and its staff, CIPF and other Canadian exchanges, recognized self-regulatory organizations and regulatory authorities, including without limitation those responsible for the supervision or regulation of securities firms and financial institutions.

13. — Listed Company Regulation

The listing requirements (initial and continuous) foster investor confidence and are not contrary to the public interest.

14. — Additional Information

The TSE has provided any additional information, as required.

Recognition Term and Condition: Upon implementation of the Alternative Trading System proposal, the TSE will be required to file any information required under Form 21-101F1.

Via Fax (593-8240), E-mail & Delivered

December 21, 1999

Ms. Randee Pavalow
Ontario Securities Commission
20 Queen Street West
Suite 1800, Box 55
Toronto, Ontario
M5H 3S8

Dear Ms. Pavalow:

Re: Proposed Recognition Criteria for the TSE

This letter sets out the position of The Toronto Stock Exchange (the "TSE") on the Ontario Securities Commission's (the "OSC") proposed criteria for recognition of the TSE in the context of its proposed demutualization by way of continuance under the Business Corporations Act (Ontario). These views reflect discussion between TSE and OSC staff on the criteria. Where appropriate, the continued corporation is referred to as TSE Inc.

Corporate Governance

The TSE Board of Governors has, independently of the demutualization initiative, substantially reformed its approach to corporate governance over the last several years. The Board has increasingly focussed on strategic, instead of operational, issues. The number of independent directors has increased markedly, with a majority of directors now being independent of member firms.

With demutualization, the Board of Directors will increasingly concentrate on strategic business issues, while continuing its stewardship of the TSE's self-regulatory functions. The Board is evolving to a corporate board model, as the ownership of the Exchange is transferred to shareholders. Over time, the shareholders are expected to increasingly be different than the securities firms which have access to the TSE's market. After demutualization, these firms will become Participating Organizations ("POs"); the existing concept of member firms will essentially become obsolete.

The TSE Inc. Corporate By-law will require that at least 50% of the directors be independent of POs. We believe this practice is consistent with the best practices in the governance of stock exchanges. At this time, the shareholders and the POs are identical. Therefore, by ensuring that a majority of the directors are independent of POs, TSE Inc. has addressed the main conflict which

exists in its governance. The make-up of the board will evolve over time, as the shareholders change. Because of share transfer restrictions and restrictions on ownership interests in TSE Inc., it will not be possible for an individual shareholder, or a group of shareholders acting together, to obtain substantial influence over TSE Inc. without the prior consent of the OSC. The OSC will therefore be in a position to ensure that the board is appropriately constituted prior to consenting to any party holding or voting over 5% of the shares.

The composition of the Board will ensure that the primary stakeholders in the Exchange are meaningfully represented. The OSC will also ensure public accountability through its continuing oversight of TSE Inc.

It must also be recognized that the purpose of demutualization is to enable the TSE to compete with other markets and trading systems by focussing on customer needs through a for-profit mandate.

TSE Inc. will be a recognized exchange that is overseen by the OSC. This recognition is a pre-condition of its operation as a stock exchange. It would be contrary to the interests of TSE Inc. to pursue any activity that would threaten its recognition or its relationship with the OSC. The OSC's oversight authority over TSE Inc. takes several forms, including approval of rules and periodic oversight examinations, and enables the OSC to ensure TSE Inc. responds to the public interest in operating its market and carrying out its SRO mandate.

The composition of the Board will ensure that the primary stakeholders in the Exchange are meaningfully represented. The OSC will also ensure public accountability through its continuing oversight of TSE Inc.

The TSE's Governance Committee, a subcommittee of the Board, determines the qualifications of directors and is responsible for recommending candidates for directors to the Board. The Board will subsequently nominate candidates to be elected by the shareholders. Remuneration will be determined by the Board as necessary to attract and retain appropriate candidates.

Exchange management and the Board of Governors receive advice from several standing and special committees which are made up of senior representatives from the securities industry, the investment community and listed companies. The composition and mandate of these committees are determined by the Board. Current standing committees include the Equities Procedure Committee, the Trading Policy Committee, the Stock List Committee, and the Specialist Appointment and Performance Review Committee. The Hearing Committee, which is essentially a roster of persons who sit on disciplinary hearings, is also set by the Board.

The Exchange also creates or sponsors special committees from time to time, with specific mandates respecting issues such as alternative trading systems, Year 2000 testing and compliance and mining standards.

In addition to standing and special committees, the Board has established several standing subcommittees of the Board, which are comprised of Board members. Currently these are the Appointments Committee, Finance and Audit Committee, Governance Committee, Human Resources Committee and Strategic Policy Committee.

The TSE has also created and supported the TIPs/HIPs Discretion Committee, as an independent

committee, with responsibility to instruct the TIPs and HIPs fund trustees as to the manner of voting core asset shares of constituent companies in the funds in such circumstances as takeover bids or mergers. This Committee will disband when the TIPs and HIPs funds are merged into the new S&P/TSE 60 Fund.

The Exchange's current standing committee structure is being examined in order to ensure that the quality and added value of the advice which is received will be optimized in the Exchange's new corporate environment, and that the composition of the committees is appropriately representative of the Exchange's various constituents and stakeholders outside the member firms.

The Exchange expects that restructuring of its committees will be completed by year-end and will likely result in fewer standing committees. The Board of Governors has received a report from the Governance Committee on this issue. As a result, the Specialist Appointment and Performance Review Committee will be disbanded given the TSE's plans to transfer derivatives to the Montreal Exchange. The number of non-PO representatives on committees will be increased, and introduced for the first time on the Stock List Committee.

As discussed under TSE Regulation Services (“TSE RS”), the Board proposes to form a Regulation Committee to oversee TSE RS, half of whose members will be independent of POs.

Prices and Fees

The Exchange provides a wide range of products and services for which fees are charged. The Exchange's objective is to set prices and fees on a commercial basis (in other words, based on supply and demand within a competitive environment) with the launch of TSE Inc. There are some exceptions to this general rule, notably fees for TSE Regulation Services, which will be set on a cost recovery basis and are obviously not part of a competitive market.

Generally speaking, the most significant fees, such as the access fee for Participating Organizations and trading fees, are determined by the Board. Fees for original listings, sustaining fees and corporate finance filing fees are generally determined by management, although material changes may be approved by the Board. Market data fees are generally determined by management. Regulation Services fees will be determined by the Board. All prices and fees are subject to review by the Board. Accordingly, any conflicts should be addressed via the governance mechanisms in place at the Board level.

The Exchange's fee structure is not currently the subject of OSC review. As a general proposition, the Exchange believes prices and fees will be subject to market disciplines with the conversion to a for-profit business model in an increasingly competitive environment for exchange services. In particular, TSE Inc. trading fees must be set at a level that encourages liquidity by facilitating both access and trading.

Apart from Regulation Services fees, fees will be determined on a “business case” and “business line” approach. Accordingly, TSE Inc. will strive to reasonably allocate costs to the relevant business lines. See the discussion on TSE Regulation Services below. We expect that market forces will be the dominant criterion in setting fees going forward outside the Regulation Services area.

Access to Market

Requirements to access the TSE will remain the same as today, except for the changes necessitated by substituting POs for member firms. The right to access the TSE market will be a contractual relationship, instead of by membership and ownership of a “seat” as is currently the case. The current membership approval process includes due process protection for applicants, which will remain the case. In particular, anyone denied access (or anyone granted access under terms and conditions not imposed on all other POs) will have a right to appeal that decision internally and ultimately to the Board. Board decisions are, of course, subject to OSC review.

Financial Viability of TSE Inc.

As of December, 1998, the TSE has internally restricted \$92.1 million in respect of approved capital and operating expenditures, and in order to provide financial resources to sustain operations should revenue decline from historical or budgeted levels for a period of time. This reserve is not available for distribution to shareholders. The TSE sees no need to establish an additional reserve to maintain its ongoing viability. The establishment of a contingency fund would impose costs without providing any additional assurances beyond those that will be required by the TSE's Board of Directors and shareholders in the normal course of business.

The TSE is fully committed to meeting all reasonable disclosure requirements requested by the OSC with respect to interim reporting and early warning on financial results. These measures, in addition to those placed on the organization by shareholders and creditors, should provide sufficient evidence and early notice of any financial situation that would require intervention or could possibly affect other participants in the capital markets.

Rather than a reserve, which we feel is not a particularly useful concept for an exchange that does not hold customer funds, and which would have to draw on the reserve for a wide variety of purposes if it were in financial difficulty, we propose a requirement for quarterly financial statements to be filed with the OSC within 60 days of quarter end, and a requirement that TSE Inc. promptly notify the OSC of any material liquidity or solvency issues as part of an early warning approach.

The TSE Inc. has proposed an “early warning” approach to an issue raised by staff concerning the ongoing viability of TSE Inc. and the impact on market participants of any disruption in TSE Inc.'s services.

We have suggested that quarterly financial statements be filed within 60 days of the quarter end and annual financial statements within 90 days of year-end. In addition, as part of an “early warning system”, TSE Inc. management would be required to promptly notify its Board and the OSC of any material liquidity or solvency issues.

In particular, the TSE Inc. is proposing that it will promptly notify the OSC with respect to its financial position. In this regard, we are proposing the following ratios be calculated on a monthly basis:

(1) Liquidity: For the TSE, this is defined as the excess of working capital and borrowing capacity over two years of net operating and capital investment requirements (both adjusted for an economic downturn), plus debt repayment.

The assumptions and definitions used here are:

- Working capital = current assets-current liabilities
- Borrowing capacity = 50 per cent of accounts receivable + 50 per cent of net capital assets
- Downturn assumptions:
 - 80% of annual revenue of the year prior to the downturn. The rationale here is that as far back as the mid-70's, the Exchange's revenue decline has never exceeded 18%.
 - 95% of current level of expenses (excluding depreciation). Some cost saving measures would be implemented.
 - 50% of the average annual capital expenditures for the past 3 years.

Some technology would reach obsolescence and necessitate replacement.

The early warning will trigger when this excess becomes a deficiency.

(2) Solvency Ratio: Defined as Assets/Liabilities. The early warning will trigger when this ratio declines to a figure of 1.3:1.

(3) Financial Leverage Ratio: Defined as Assets/Capital. Essentially the flip side of solvency, the early warning will trigger when this figure rises to 4.0.

The TSE Inc. understands that in any such event the OSC may wish to impose additional terms and conditions on the ongoing operations of TSE Inc. if the OSC believes that its financial viability is in question. TSE Inc. notes it would have the right to subsequently contest any such terms and conditions.

The TSE undertakes to report annually the monthly calculation of the above ratios. The TSE Inc. also undertakes to advise the Commission annually in the event that it believes the foregoing tests are no longer appropriate to the TSE Inc.'s circumstances and should be revised. In any event, after two years the TSE will reassess the appropriateness of the early warning ratios and report to the OSC thereon.

In a competitive market, one cannot “ensure” financial viability. The best way to do so is to operate competitively and efficiently, and TSE Inc. will seek to do so.

TSE Regulation Services

Regulatory Model

The design of an appropriate market regulation function is an important issue to be addressed in the context of demutualization of the TSE. This issue was canvassed extensively by Exchange

management following the release of “A Blueprint for Success” and was addressed in the information circular for the June 10, 1999 members' meeting.

There are several components of the TSE's market regulation program: listed company regulation, monitoring of trading operations and of market-related activities of TSE members and their customers, determination and administration of trading rules, market surveillance capabilities, investigation and enforcement, as well as support functions such as policy development and information technology. These activities are essential to maintaining market integrity and fairness.

The TSE recognizes that it must devise an appropriate model for market regulation in the context of becoming a for-profit company and a competitive environment in which alternative trading systems also provide trading services.

In their ATS Proposal, the CSA propose to require ATSS that are not members of a recognized exchange to enter into an agreement with an “approved agent” to enforce compliance with proposed CSA trading rules (including rules relating to price manipulation, short selling, deceptive trading, front running, insider trading and principal trading). The TSE would be an approved agent to supply market regulation services to non-member ATSS.

There are a number of criteria against which to evaluate any proposed regulatory model:

- The model should support the role of self-regulation, given the need for responsiveness in the development and application of rules to enhance the competitiveness of Canadian capital markets.
- The model should establish market regulation as a separate and fully transparent cost/revenue centre. Trading operations (which will come under increasing cost and price pressure) should not subsidize regulation, or vice versa.
- Market regulation should not be a profit centre because that might introduce inappropriate incentives. Users of market regulation services should bear their fair share of the costs thereof.
- Given the dynamic nature of policy in this area and of evolving market structure, any model should minimize bureaucratic costs and rigidity and should be flexible enough to allow for co-operative initiatives (e.g., sharing services and/or infrastructure) with other market authorities. The ATS Proposal contemplates co-ordination among all “approved agents” providing market regulation services.
- Devising a market regulation model for TSE Inc. should proceed independently of the CSA's ATS Proposal, in order to facilitate expeditious implementation of demutualization, but should be flexible enough to enable TSE Inc. to respond to the final version of the ATS Proposal, as well as to enhance its reputation through continued high quality regulation.
- The model should effectively address concerns over conflicts of interest that currently exist, or that may arise from TSE Inc. operating as a for-profit entity, or being both a market operator and regulator.
- An effective governance structure is an important element in effectively addressing such conflicts. In our view, this requires a governance mechanism which includes representatives

of the full range of regulated firms, and strong representation of stakeholders that are independent of these firms. In designing an appropriate governance structure, it should also be recognized that the TSE regulates listed companies.

In order to address these policy objectives, the TSE's market regulation functions will be established as a separate division of TSE Inc. ("TSE Regulatory Services" or "TSE RS"), with clearly defined responsibilities and a high degree of managerial autonomy. TSE RS will be a separate and fully transparent cost centre, with a view to clearly identifying the costs of regulation and passing them through to POs and listed companies. Segregating the market regulation functions in a distinct "business unit" should enhance transparency and accountability, as well as facilitate effective OSC oversight of TSE Inc.'s regulation functions.

The TSE recognizes that the introduction of ATSS into the marketplace to compete with the TSE raises questions of conflict of interest which need to be addressed in the operation of the TSE's self-regulatory responsibilities. The question of how market regulation will be delivered with the introduction of ATSS is a question which must be resolved. The TSE is of the view that market regulation (including listed company regulation, market surveillance, determining, administering and monitoring compliance with trading rules, and investigations and enforcement) are essential both to maintaining the TSE's market integrity and to protecting the TSE's brand and reputation as a credible and fair marketplace.

Market regulation is thus integral to the operation of the TSE's market. The TSE does not favour any model which might compromise current standards of market regulation. This could have a significant negative impact on both the TSE's market quality and reputation, and on Ontario's capital markets generally.

However, there is a great deal of uncertainty present as the CSA move forward with their ATS Proposal. We cannot predict the final form of the ATS regime, how many new entrants will arrive, and how ATSS will choose to be regulated and carry on business. Similar uncertainty is present in the US surrounding the treatment of both member and market regulation in the context of the demutualization of the NYSE, NASDAQ and other exchanges. Globalization and technological developments are contributing to the uncertainty by fostering continuous change in the markets.

Given this state of uncertainty, the TSE Inc. has proposed a flexible model to address conflict of interest concerns arising from the fact that the TSE Inc. will be a regulator as well as a market operator, and will be operating as a for-profit entity, by establishing a separate division of the TSE Inc. to deliver regulatory services. The TSE acknowledges this model may be transitional, and it can be adapted to become more independent as the market evolves.

The TSE RS model was designed specifically to address demutualization. It also anticipates, but does not fully address, the market environment following implementation of the ATS Proposal, because the content of the Proposal is still being discussed. The TSE RS model has been designed to be flexible. If in future it proves desirable to establish TSE RS as a separate entity with its own board of directors, much of the "separation" will already have been achieved. At the same time, given the current degree of uncertainty and rapid pace of change, committing to a significantly different model prematurely will create significant immediate and ongoing transitional costs and

may be difficult to change if it proves to be an inappropriate model. Again, the TSE believes market regulation is an essential component of its services as a regulated market. Our model is designed to preserve these benefits, while addressing concerns about conflicts of interest.

It is also not clear that a separate subsidiary, with a board of directors whose fiduciary duties are to the subsidiary (and its sole shareholder, the TSE Inc.), would lead to any appreciable differences in the delivery of market regulation services, although clearly it would have significant costs and would require the creation of a cumbersome new bureaucratic structure.

Recently, the TSE's Board discussed the issue of the appropriate model for market regulation again, in light of comments on the ATS Proposal. The Board has formed a subcommittee to work with management in developing a report to the full Board on this issue in the 1st quarter of 2000. The Board's discussion of the report could lead to further changes to the TSE RS model, or to discussions with other industry participants on the regulatory model.

The TSE Inc. has indicated to OSC staff that it is willing to provide an undertaking that it will reassess TSE RS's operations and structure 12 months from the effective date of demutualization, and report to the OSC thereon.

In the meantime, the Exchange believes that the TSE RS model is an appropriate response at this time, given the uncertainty in the market environment driven by demutualization, the pending introduction of ATSS, and developments in the US market. It will also give TSE Inc. an opportunity to assess the operational implications of demutualization, and the market a chance to assess TSE RS in operation.

TSE RS — Recognition Order

The independence, mandate and obligations of management of TSE RS are proposed to be prescribed as terms and conditions of TSE Inc.'s recognition order.

TSE RS will operate on a cost recovery (rather than for-profit) basis and will maintain separate financial records. "Chinese wall" procedures will be implemented to ensure that confidential information does not cross inappropriately from TSE RS to any of the TSE's (or other market operators') business lines. Such procedures will reinforce those presently in place with respect to confidential information.

The terms and conditions of the proposed recognition order would, in addition to dealing with such matters as annual reporting, reporting to the OSC of material problems with POs, co-operation with other regulators and investigation and disciplinary matters, set out a comprehensive set of terms and conditions relating to the operations of TSE RS.

These proposed terms and conditions would, among other things:

- require prior OSC approval of significant changes to the structure of TSE RS
- require the functions of TSE RS to be carried out independently and on a cost-recovery basis
- provide for oversight of TSE RS by a special Regulation Committee of the Board with special reporting lines from the COO of TSE RS to the OSC

- require that TSE RS have a segregated budget and be allocated the necessary technological and other support it needs
- require TSE Inc. to adopt procedures to deal with confidential information relating to TSE RS
- require TSE Inc. to maintain the ability of TSE RS to perform its market regulation functions
- require performance reviews of TSE RS's operations at least annually

These terms and conditions are designed to ensure that TSE RS operates efficiently, effectively and fairly as a division of TSE Inc.

In summary, the TSE believes that the governance structure for TSE RS outlined above is more appropriate at this time than establishing a separate subsidiary with its own board of directors, because it will be more efficient. The TSE does not believe that management of conflicts of interest should be an issue, given the make-up of the Board and Regulation Committee. Consequently, we believe that the costs of establishing an independent entity outweigh any potential benefits at this time. This may be a transitional phase, and over time, an increasingly independent regulatory entity or subsidiary may be appropriate, as market structure and regulatory frameworks evolve.

SE RS — Finances

The following outlines the TSE's proposed approach to the financial model and reporting of financial statements as they pertain to TSE Regulatory Services.

Segmented Reporting:

In general the TSE will follow the CICA guidelines, Section 1701 — which stipulates the requirements for segregated disclosure. In addition, regardless of whether TSE RS meets the GAAP thresholds for separate disclosure, in an effort to maintain transparency and accountability, the TSE will publish segmented financials for TSE RS.

Revenue:

It is proposed that TSE RS will develop its own pricing model and charge users directly for its services. These revenues will be captured separately and will be reported as regulatory revenue. The Board of Governors will establish the fee structure for TSE RS in the near future. In addition, certain regulatory services (e.g. Corporate Finance Services) will be provided for other business lines within the TSE. These will also be charged on a cost recovery basis and separately tracked and reported.

Expenses:

TSE operations are separated into numerous cost centres. Certain cost centres are dedicated to TSE RS and can be directly charged to TSE RS, while others represent shared functions that support several or all of the TSE's business lines.

Income Statement:

The TSE will make reasonable efforts to clearly separate, both from operational and accounting standpoints, Regulatory Services' costs and revenues from those of other business lines within TSE Inc. In those areas where shared services provide economic or operational benefits, costs will be allocated to TSE RS using clearly defined allocation methodologies. In instances where allocations are required the TSE will apply the primary principle of using the most accurate method of allocation, allowing for cost/benefit of effort and consistency of application across the Exchange. As business needs and information requirements change, the allocation methodologies are subject to change, however the underlying principle stated above will remain in effect.

Retained Earnings:

As TSE RS will be operated on a not-for-profit basis, independent of the equities trading and other businesses, annual budgets will be set with an objective to break even. However, in any given year, market conditions and unforeseen events will inevitably affect the forecast either positively or negatively. Actual results will be closely monitored and pricing will be adjusted when appropriate. However, TSE RS will take a longer-term view on revenues and pricing, and will not necessarily adjust pricing to ensure an annual break-even position. The goal will be to remain not-for-profit over an extended time period and accumulated surpluses or deficits will be tracked through segregated retained earnings.

Balance Sheet:

Due to the integration of the TSE's assets and liabilities, the TSE will not prepare a separate balance sheet for TSE RS. However, assets purchased directly on behalf of TSE RS will be tracked and reported separately.

Financial Statements:

The TSE proposes to observe the same deadline for filing annual financial statements which applies to reporting issuers generally.

Allocation Methodology

The TSE Inc. proposes to use the following cost allocation methodologies for TSE RS. The TSE will report any change in the methodologies in its annual report to the OSC.

Information Systems Development and Support

There will be separate and distinct cost centres and staff that will provide support to each of the individual business lines.

Information Systems Operation

In order to establish “estimated effort” I.S. management has reviewed the number of staff and the effort they spend supporting the different applications and has then attributed those applications to the different business lines. In 1999 a time tracking system was implemented. As we move forward, we will be able to collect more accurate data with respect to the time spent supporting the applications and the business lines. The cost allocations will then periodically be updated.

Technology utilization refers to the usage of the physical hardware and software that supports the programs run for the different business lines. In those cases where a physical box/program is solely dedicated to a business line, 100 per cent of the costs of software maintenance, support and licenses are attributed to the business line. In cases where more than one program is maintained on similar hardware, the costs are allocated based on resource utilization, eg. CPU, Disk, Tape, Ports, Network.

Overhead

The direct costs are those cost centres (which contain staff and expenses) that are clearly attributable to a particular business line. For example the Member and Investor Services department is directly charged to the Equities business line. The Market Surveillance department is charged directly to TSE RS. The TSE RS direct costs are then divided by the sum of the direct costs for each of the business lines to determine their percentage of the overhead costs. The TSE recognizes that this may not be as accurate as other methodologies available, however, the effort required to implement an alternative does not justify the increase in accuracy. As a means of improving the accuracy, all easily distinguishable costs i.e. external legal fees and specific marketing programs are charged to the cost centres that are classified as “direct”, and thus are reflected against the correct business line.

Depreciation

Shared facilities and equipment are allocated based on headcount.

Other

Interest income will be allocated based on P&L + Depreciation — Capital Investments.

Systems Capacity and Integrity

We understand that OSC staff are satisfied with the Exchange's initiatives in this regard.

Purpose of Rules

We propose that this requirement be included in the recognition order. We do not anticipate substantial changes to the existing rules.

Rules and Rule-Making

The existing protocol between the TSE and the OSC on approval of TSE rules will continue in effect. However, as competition increases, the TSE sees a clear need to enable TSE Inc. to introduce new services and trading methods without needing to obtain prior approval from the OSC.

In preparation for demutualization, the TSE has rationalized its trading rules. Today, these are contained in General By-law provisions, Policy Statements and Board Rulings. Upon demutualization, the by-laws of TSE Inc. will be standard corporate by-laws. Exchange rules will be contained in a trading rulebook and the listed Company Manual. We have decided to maintain 2 separate books as the audiences will be different, although certain rules that are relevant to both audiences (e.g. the sale from control rules) will be contained in both books.

As a result of this exercise, the TSE has reorganized the trading rules into a more logical sequence. Obsolete rules have been repealed and some rules have been redrafted to provide greater clarity. The categorization has been clarified, so that any mandatory provision is designated a rule and any interpretive provision is designated a policy. The rulebook does not make any substantive changes to the rules other than those required to give effect to demutualization and realignment (for example, repealing the membership provisions and the rules for trading derivatives).

The trading rulebook has been published for comment. The changes to the Company Manual required to give effect to demutualization will be minimal as the manual has traditionally contained all of the rules applicable to listed companies. The changes will largely consist of amending references to specific sections of the General By-law and replacing references to members with references to Participating Organizations.

Financial Statements

As noted above, annual and quarterly financial statements will be provided to the OSC, with segmented reporting for TSE RS.

Discipline

The proposed legislation will extend the disciplinary powers provided by current s. 10 of the Toronto Stock Exchange Act going forward.

Due Process

The TSE believes that its procedures are fair and reasonable and provide for due process.

Application Form for Recognition

The TSE questions whether filing on the draft Form 21-101F1 set out in the ATS Proposal is appropriate. The ATS rule is not yet in force, and substantial comments have been made on the

proposed form, which appears to the TSE to be excessively detailed. The TSE has provided the information set out in Appendix A, as requested by OSC staff. We would be pleased to respond to any other specific inquiries.

Thank you for the opportunity set out the TSE's position on the proposed recognition criteria.

Sincerely,

John Carson
Senior Vice-President, Market Regulation

cc:

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