

**1.1.7 OSC Staff Notice 21-702 Regulatory Approach  
for Foreign-Based Stock Exchanges**

**OSC STAFF NOTICE 21-702  
REGULATORY APPROACH FOR FOREIGN-BASED  
STOCK EXCHANGES**

**I. Introduction**

Staff of the Ontario Securities Commission (Staff) have received a number of inquiries from foreign-based stock exchanges interested in operating in Ontario. In response to these inquiries, Staff are proposing an approach to regulation of foreign-based stock exchanges that is aimed at facilitating investor choice while maintaining high standards of investor protection and market integrity.

This notice sets out the approach that Staff will use when evaluating the requests and making recommendations to the Commission regarding the appropriate level of regulation for foreign-based stock exchanges that wish to provide Ontario residents direct access to their markets.

**II. The Regulatory Framework for Stock Exchanges**

Section 21 of the *Securities Act* (Ontario) (the Act) provides that “no person or company shall carry on business as a stock exchange in Ontario unless recognized by the Commission under this section.”

A foreign-based stock exchange is an exchange that is operating outside of Canada and is subject to regulation by a government authority responsible for the oversight of the exchange (home regulator). A foreign-based stock exchange that seeks to provide direct access to Ontario residents will be considered to be carrying on business in Ontario and must either apply for recognition under section 21 of the Act or apply for an exemption from recognition under section 147 of the Act. With increasing reliance on technology systems, Staff believe that a “carrying on business” test that relies solely on a physical location does not address the realities of the global capital markets.

**(a) Recognition of Stock Exchanges**

A foreign-based stock exchange that seeks to carry on business in Ontario may apply for recognition under section 21 of the Act. The application process for a foreign-based stock exchange is the same as the one used for the recognition of a domestic-based stock exchange.<sup>1</sup> An application for recognition should include a description of the operations of the exchange and how the exchange meets criteria that deal with the following:

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<sup>1</sup> For an example of an application for recognition, please see the Toronto Stock Exchange Inc. Recognition: dated April 3, 2000, 23 O.S.C.B. 2495; amended January 29, 2002, 25 O.S.C.B. 929 and September 3, 2002, 25 O.S.C.B. 6134.

- corporate governance
- fees
- access
- information sharing
- fitness of officers and directors
- listed company rules
- financial viability
- self-listing conditions, if applicable
- regulation of the exchange and its participants
- systems and technology
- purpose of rules of the exchange

The detailed criteria are attached to this notice as Schedule A. The criteria reflect the characteristics that the Commission considers that a stock exchange, foreign or domestic, must have in order to protect the public interest and Ontario investors.

A recognition order issued by the Commission under section 21 may be subject to terms and conditions that are determined based on how the applicant satisfies the criteria and any other factors relevant to the applicant. Generally, if an exchange is recognized it will be required to:

- file rules, policies and other similar instruments for approval by the Commission
- file financial statements
- file quarterly and annual reports containing information relating to its participants access, investigations, listings, exemptions granted, and other items
- comply with the Automation Review Program<sup>2</sup>
- submit to examinations and reviews conducted by Staff
- comply with the terms and conditions modeled on the criteria described above

Any breach of a term and condition of the recognition order is a contravention of Ontario securities law.

<sup>2</sup> The Automation Review Program (“ARP”) provides a mechanism for any specified market infrastructure entity to follow a formal methodology in identifying and managing information technology risk. For a copy of the ARP, please see (2002) 25 OSCB 6789 and <http://www.osc.gov.on.ca/en/HotTopics/marketplace.html>

**(b) Exemption from Recognition**

A foreign-based stock exchange that seeks to carry on business in Ontario may alternatively apply for an exemption from recognition under section 147 of the Act.

*(i) Rationale for Granting an Exemption*

Staff acknowledge that most foreign-based stock exchanges are already subject to a regulatory regime in their country of origin (home jurisdiction). Full regulation, similar to that applied to domestic exchanges, may be duplicative and inefficient when imposed in addition to the regulation of the home or another jurisdiction. As well, orders entered onto and trades executed on the foreign-based stock exchange should be subject to the same market rules, no matter where the investor is located or the order is entered. However, the regulatory regime of the home jurisdiction may not have a similar level of investor protection as that in Ontario and, in addition to some basic requirements to ensure ongoing consistency, the Commission may consider it necessary to impose additional requirements.

In developing the approach for regulating foreign-based exchanges, Staff believe that investor protection must be balanced with efficient markets when facilitating access to foreign-based stock exchanges. Staff propose to achieve this balance by requesting that the foreign-based stock exchange establish at the time of application that it meets the same criteria that a domestic exchange must meet and that access must be through an Ontario registrant. The criteria may be slightly tailored to the specific structure of the foreign-based stock exchange, the products traded on the exchange, or its regulatory environment. The foreign-based stock exchange may meet the criteria either through its own rules or the laws of the home regulator. Investor protection is achieved through the criteria and the gatekeeping role of the Ontario registrant. (Please refer to Part III). Once the foreign-based stock exchange has met the criteria at the time of the application and has established that it is subject to an appropriate regulatory regime, Staff propose that the foreign-based exchange will not be subject to many of the ongoing requirements that are applied to domestic exchanges (e.g. approval of rules, policies or similar instruments and regular examinations).

Staff propose to recommend to the Commission to exempt the foreign-based stock exchange, rely upon the regulatory regime of the home regulator and impose appropriate terms and conditions. The specific terms and conditions applicable to the foreign-based stock exchange may vary depending on the operations of the foreign-based stock exchange, the methods of access for its participants, and the regulatory regime in its home jurisdiction. The purpose of these terms and conditions is to enable the Commission to have access to information on the operations of the foreign-based stock exchange and the trading activity of Ontario participants. The following terms and conditions will be considered:

- ongoing compliance with home jurisdiction and oversight
- prior notice of material changes to the application
- quarterly and annual reporting of information relating to operational activities
- access restrictions
- financial reporting
- disclosure to investors regarding the regulatory structure, the implications of the exemption and the legal rights of an investor
- information sharing
- home jurisdiction adherence to IOSCO standards
- submission to non-exclusive jurisdiction

Breaches of a term and condition in the exemption order by the foreign-based stock exchange would be a contravention of Ontario securities law.

### III. Access through Registered Intermediaries

Access to the foreign-based stock exchange will be subject to Ontario securities laws and, in particular, the Ontario registration regime. The foreign-based stock exchange may provide direct access, either through terminals, data feeds or third party provided interfaces, to only those persons that are duly registered or licensed under the laws of Ontario. If an Ontario participant in a foreign-based stock exchange breaches the rules of that exchange or breaches Ontario securities laws while trading on the foreign-based stock exchange, the Commission or the appropriate self-regulatory organization may take action against that participant.

### IV. Other Jurisdictions

Reliance on foreign country regulation has been adopted by a number of foreign regulators, including the Australian Securities and Investment Commission (ASIC) and the Commodity Futures Trading Commission (CFTC) in the United States. Both ASIC and the CFTC have recognized the home country regulation of foreign-based exchanges and have allowed foreign-based exchanges to operate within their jurisdictions by imposing certain terms and conditions. This approach eliminates duplicative regulation while ensuring that securities markets and foreign-based stock exchange participants are subject to a uniform standard of regulation.

### V. Application Process

The application process for both recognition and exemption from recognition as a stock exchange is the same. The foreign-based stock exchange must file an application, detailing for example, its history, business and regulatory structure and addressing how it meets the specific criteria

as outlined in Appendix A. After receipt of the application, Staff will provide comments on its content and will work with the applicant to ensure that the application contains all of the requisite information and to develop a draft order. Once the application and order have been finalized, Staff will request that the Commission approve the publication of the application and the order for a 30 day comment period. Publication will occur in the OSC Bulletin and on the OSC website. Once all issues raised during the comment process are resolved, Staff will submit the order for approval to the Commission in the form of the published order, as amended in response to the comment process. Once issued, the order will be published in the OSC Bulletin and on the website.

### VI. The Commodity Futures Act

The *Commodity Futures Act* (Ontario) imposes a similar regime for commodity futures exchanges that carry on business in Ontario. Section 15 provides that no person or company may carry on business in Ontario unless registered by the Commission as a commodity futures exchange. We would consider following a similar regulatory approach to foreign-based commodity futures exchanges as we have outlined above for foreign-based stock exchanges.

### VII. Further Information

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## APPENDIX A

### CRITERIA FOR RECOGNITION AND EXEMPTION FROM RECOGNITION

Responses to all of the following criteria must address:

- (i) how the Exchange meets each criterion;
- (ii) what requirements, if any, are imposed by the applicable regulator in the Exchange's jurisdiction (the Foreign Regulator) in each area; and
- (iii) how the oversight of the Exchange by the Foreign Regulator ensures ongoing compliance with the criterion.

#### PART 1 CORPORATE GOVERNANCE

##### 1.1 Fair Representation

The governance structure of the Exchange provides for:

- (i) appropriate, fair and meaningful representation on its Board and any committee thereof, and
- (ii) appropriate representation by independent directors on the Board and any committee thereof.

##### 1.2 Appropriate Provisions for Directors and Officers

The Exchange takes reasonable steps to ensure:

- (i) appropriate qualifications, remuneration, limitation of liability and indemnity provisions for directors and officers; and
- (ii) each officer and director is a fit and proper person.

##### 1.3 Conflicts of Interest

The Exchange has appropriate conflict of interest provisions for all directors, officers and employees.

#### PART 2 FEES

##### 2.1 Fees

The Exchange's process for setting fees is fair, transparent and appropriate. Any and all fees imposed by the Exchange on its participants are equitably allocated, do not have the effect of creating barriers to access and are balanced with the criterion that the Exchange has sufficient revenues to satisfy its responsibilities.

#### PART 3 ACCESS

##### 3.1 Fair Access

The requirements of the Exchange relating to access to the facilities of the Exchange are fair, transparent and reasonable and include requirements in respect of notice,

an opportunity to be heard or make representations, the keeping of records, the giving of reasons and the provisions for appeals.

##### 3.2 Details of Access Criteria

In particular, the Exchange:

- (i) has written standards for granting access to trading on its facilities to ensure users have appropriate integrity and fitness;
- (ii) has and enforces financial integrity standards for those persons who enter orders for execution on the system, including, but not limited to, credit or position limits and clearing membership;
- (iii) does not unreasonably prohibit or limit access by a person or company to services offered by it;
- (iv) keeps records of each grant and denial or limitation of access, including reasons for granting, denying or limiting access; and
- (v) restricts access to adequately trained system users who have demonstrated competence in the functions that they perform.

##### 3.3 Access for Ontario Residents

The Exchange provides direct access, either through terminals, data feeds or third party provided interfaces, to only those persons who are duly registered or licensed under Ontario laws.

#### PART 4 REGULATION

##### 4.1 Jurisdiction

The Exchange, foreign self-regulatory organization (Foreign SRO) and/or the Foreign Regulator have the jurisdiction to perform member and market regulation, including the ability to set rules, conduct compliance reviews and perform surveillance and enforcement.

##### 4.2 Issuer/Product Regulation

The products traded on the Exchange and the listing rules are approved by the appropriate authority.

##### 4.3 Member Regulation

Sales practices are fair, properly supervised and not contrary to the public interest.

##### 4.4 Transparency

Adequate provision has been made to record and publish accurate and timely trade and quotation information. This information is provided to all participants on an equitable basis.

#### **4.5 Sufficient Systems and Resources**

The Exchange, Foreign SRO and/or its Foreign Regulator maintain appropriate systems and resources for conducting member regulation and market regulation, for evaluating compliance with Exchange, Foreign SRO or legislative requirements and disciplining participants.

#### **4.6 Record Keeping**

The Exchange, Foreign SRO and/or its Foreign Regulator maintain adequate provisions for keeping books and records, including operations of the exchange, audit trail information on all trades and compliance and/or violations of Exchange requirements and securities legislation.

#### **4.7 Availability of Information to Foreign Regulator**

The Exchange and/or the Foreign SRO have mechanisms in place to ensure that the information necessary to conduct adequate surveillance of the system for supervisory and enforcement purposes is available to the relevant regulatory authorities on a timely basis.

### **PART 5 RULEMAKING**

#### **5.1 Purpose of Rules**

The Exchange and the Foreign SRO maintain rules, policies and other similar instruments designed to, in particular:

- (i) ensure compliance with the rules of the Exchange and the Foreign SRO;
- (ii) prevent fraudulent and manipulative acts and practices;
- (iii) promote just and equitable principles of trade;
- (iv) foster co-operation and co-ordination with persons or companies engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in, the products traded on the Exchange;
- (v) provide for appropriate discipline;
- (vi) ensure a fair and orderly market;
- (vii) ensure that the Exchange business is conducted in a manner so as to afford protection to investors; and
- (viii) provide for appropriate dispute procedures.

#### **5.2 No Discrimination or Burden on Competition**

The rules of the Exchange and the Foreign SRO do not:

- (i) permit unreasonable discrimination among issuers or participants; or

- (ii) impose any burden on competition that is not reasonably necessary or appropriate.

### **PART 6 SYSTEMS AND TECHNOLOGY**

#### **6.1 System Capability/Scalability**

For each of its systems that support order entry, order routing, execution, data feeds, trade reporting, trade comparison and system-enforced rules, the Exchange maintains a level of capacity that allows it to properly carry on its business and has in place processes to ensure the integrity of each system. This includes maintaining reasonable back-up, contingency and business continuity plans, disaster recovery plans and internal controls.

#### **6.2 Information Technology Risk Management Procedures**

The Exchange has procedures in place that:

- (i) handle trading errors, trading halts and circuit breakers;
- (ii) ensure the competence, integrity and authority of system users; and
- (iii) ensure that the system users are adequately supervised.

### **PART 7 FINANCIAL VIABILITY**

#### **7.1 Financial Viability**

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

### **PART 8 CLEARING AND SETTLEMENT**

#### **8.1 Relationship with Clearing Agency**

The Exchange has a clearing relationship with an established clearing agency (Clearing Agency) and all transactions executed on the Exchange are cleared through the Clearing Agency.

#### **8.2 Regulation of the Clearing Agency**

The Clearing Agency is subject to regulation by the Foreign Regulator that addresses risk and promotes transparency, fairness and investor protection.

#### **8.3 Authority of the Foreign Regulator**

The Foreign Regulator has the appropriate authority and procedures for oversight of the Clearing Agency. This oversight includes regular, periodic regulatory examinations of the Clearing Agency by the Foreign Regulator.

#### **8.4 Clearing and Settlement Arrangements**

The Exchange is satisfied that appropriate clearing and settlement arrangements are in place to provide

reasonable assurance that all obligations arising out of transactions on the Exchange will be met.

#### **8.5 Restrictions on Access to a Foreign Member**

Any restrictions on access to the clearing system by a foreign member are adequately disclosed and justified by the legislation of the home jurisdiction, are not anti-competitive and do not unreasonably impose barriers to access.

#### **8.6 Technology of Clearing Corporation**

The Exchange has assured itself that the information technology used by the Clearing Agency has been adequately reviewed and tested and provides at least the same level of safeguards as required of the Exchange.

#### **8.7 Risk Management of Clearing Corporation**

The Exchange has assured itself that the Clearing Agency has established appropriate risk management policies and procedures, contingency plans, default procedures and internal controls.

### **PART 9 INFORMATION SHARING AND OVERSIGHT ARRANGEMENTS**

#### **9.1 Information Sharing and Oversight Agreement**

Satisfactory information sharing and oversight agreements exist among the Commission, the Foreign Regulator and/or the Foreign SRO.

#### **9.2 Co-operation**

The Exchange will co-operate by the sharing of information and otherwise with the Commission and its staff.

### **PART 10 IOSCO PRINCIPLES**

#### **10.1 IOSCO Principles**

Regulation and oversight of the Exchange is carried out in a manner consistent with IOSCO principles.