November 2, 1999

British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Securities Commission
The Manitoba Securities Commission
Ontario Securities Commission
Office of the Administrator, New Brunswick
Registrar of Securities, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland
Registrar of Securities, North West Territories
Registrar of Securities, Yukon Territories
Registrar of Securities, Nunavut
c/o John Stevenson
Secretary, Ontario Securities Commission
20 Queen Street West
Suite 800
Box 55
Toronto, Ontario
M5H 3S8

And To:

Claude St. Pierre
Secretary
Commission des valeurs mobilières
du Quebec
800 Victoria Square
Stock Exchange Tower
P.O. Box 246
22nd Floor
Montreal, Quebec
H4Z 1G3

Dear Sirs/Mesdames:

**Re: Proposed National Instrument 21-101 Market Place Operation, National Instrument 23-101 Trading Rules, Ontario Securities Commission Rule 23-501, Designation as Market Participant and Discussion Paper entitled "Consolidation Plan for a Consolidated Canadian Market" and related companion policies and forms (the "Proposal")**

## I *Introduction*

Instinet welcomes the opportunity to comment on the first national initiative by Canadian securities regulatory authorities to adopt a uniform approach to the regulation of Alternative Trading Systems (each an "ATS"). Instinet has worked consistently over the past decade to advance the acceptance of electronic trading in Canada. It is hoped that the views offered here, which reflect Instinet's experience both as a global provider of electronic brokerage services and as a participant in the Canadian trading community, will be valuable to the Commissions. This letter is submitted by Instinet Canada Limited ("ICL") on its own behalf and on behalf of Instinet Corporation. This letter responds to issues and questions concerning ATSs in the Proposal published on July 2, 1999 by the Ontario Securities Commission (the "OSC" or the "Commission") and by the Canadian Securities Administrators ("CSA") at (1999) 22 OSCB (ATS Supp).

Instinet Corporation, the world's largest agency brokerage firm, trades in over 40 global markets daily and, directly and through affiliates, is a member of 18 stock exchanges in North America, Europe and Asia. The firm is committed to bringing efficiencies to capital raising worldwide by using technology in securities trading and research to bring issuers and investors closer together.

Instinet applies advanced technology to agency trading in securities. Clients can communicate and trade electronically either directly with each other using Instinet's block brokerage service or can link to exchanges. Instinet's technology enables it to represent pieces of a single client order simultaneously in multiple markets for a security. Clients are able to enter order on-screen and trade with institutional investors broker/dealers, market makers and exchange specialists around the world.

Unlike an ECN which provides only a simple order routing mechanism, Instinet provides its clients with the benefits of discretion and flexibility in trade execution through a wide variety of trading products and services. For example, Instinet, the global agency broker, offers its clients trading research, economic research and analysis and access to the research and investment products of third party vendors via "soft dollar" arrangements.

ICL's comments are divided into three parts: (i) general comments on the Proposal, (ii) specific comments on the Proposal (including answers to the questions raised in the Proposal) and (iii) concluding remarks.

## *II General Comments on the Proposal*

### Need for Consistency

A concept elaborated upon in our comments below is the fundamental importance of consistency between the content of the Proposal and US Rule ATS. This Proposal cannot be viewed in isolation as US ATS and Canadian ATS. A failure to achieve consistency of regulation among global markets will act as a significant deterrent to foreign-based entrants expanding their operations to include Canada.

### The "Marketplace" Concept in the Proposal Needs Elaboration

The CSA and the Commission have elected to base the Proposal on the regulation of all "marketplaces".[1] This critical definition requires elaboration in a number of respects.

First, the concepts of "exchange" and "quotation and trade reporting system", each of which represents a distinct marketplace category, are not defined in the Instrument. Each term needs an explicit definition having statutory effect. Though the term "exchange" is indirectly defined in both paragraph (c) of the definition of ATS and in section 3.1(2) of Companion Policy 21-101 CP ("Market Operation Policy"), the Policy warns "that the criteria for identifying an exchange are not exclusive" and reserves the right in unspecified "other instances" to rewrite the ground rules.

Second, the line of demarcation in the Proposal between a traditional block trading desk and an ATS is drawn in a manner that perhaps unintentionally favours more traditional trading

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[1] Draft National Instrument 21-101 ("NI") section 1.1 ("marketplace").

operations. A traditional block trading desk that telephonically matches buy and sell orders in the upstairs market is distinguished from an ATS (and is therefore not regulated as an ATS) where it retains discretion over order execution technique including, for example, the discretion to commit capital to make-up the other side of an order.[2] Thus, a broker that elects to trade as principal and commit capital to its trading activity escapes regulation as an ATS and will never be regulated as an exchange no matter how large its volume is. This result is inappropriate.

Third, in the definition of a "marketplace"[3] the boundary between an ATS and a "traditional dealer" is made to depend on the degree to which "non-discretionary" methods are employed for orders to interact with each other. Where a technologically advanced trading operation like Instinet affords its users a variety of discretionary methods for trading, it does not seem appropriate to treat that entity as a marketplace for that reason alone. This again produces a tilting of the Proposal in favour of traditional brokers.

**Treatment of ATSs in the Proposal fails to distinguish ATSs sufficiently from Exchanges**

Instinet believes that in order for the Proposal to achieve its desired impact, there must be a clear distinction between the role, method of operation and regulation of ATSs and exchanges unless an ATS itself elects to be regulated as an exchange. Although the Proposal is said to be consistent with Regulation ATS in the United States, it in fact deviates in certain substantial and important respects that make the proposed method of ATS regulation in Canada more closely resemble the regulation of exchanges than ATSs under the US rule.

The following comments identify technological and other factors that put difficulties in the way of an ATS that is already complying with United States rules.

First, the Proposal envisages the imposition by an ATS through a self-regulatory organization of codes of conduct on ATS users. This approach is more akin to exchange regulation which by definition sets requirements governing the conduct of its participants. Even though the CSA has preliminarily asserted[4] that the requirement to police subscribers does not create an

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[2] Market Operation Policy, section 2.1(5)

[3] NI, section 1.1 definition of "marketplace" (paragraph c (iii)).

[4] See Companion Policy 21-101 CP- Marketplace Operation, section 3.3(2)

inconsistency between ATS and exchange regulation, this conclusion is directly at odds with its own description of exchange characteristics in the Market Operation Policy.

Second, the approach of limiting types of ATS security to defined categories and of emphasizing in the permitted categories securities that are listed on organized markets makes ATSs function like exchanges. No compelling reason is given for limiting the types of security an ATS trades and no such limitations are imposed in the United States. If ATSs are truly intended to be distinguishable from an exchange, and Instinet believes that they must be, this result is undesirable.

Third, the prohibition on principal trading by ATSs is not given any policy justification beyond operating as a disincentive to existing exchange members which do principal trading as part of their business and might, in the absence of the disincentive, wish to withdraw from those exchanges and start free-standing ATS operations. This prohibition should be abandoned in the absence of a significant policy justification.

Fourth, proposed restrictions on "after hours" trading tie ATSs unreasonably to the exchanges' hours of operation and again make exchanges and ATSs difficult to distinguish.

**Other Comment on the Scope of ATS regulation**

A fundamental matter is the degree to which the ATS regulatory structure is successful in reaching commercial entities that purport merely to sell technology to marketplaces but are, in substance, proper candidates for ATS regulation. Instinet is not referring here to conventional arrangements for the outsourcing of technology. Rather, where a vendor sells technology to a stock exchange and the stock exchange and the technology vendor enters into a joint venture to exploit the economic benefits of the technology, both entities should be treated as the operators of the alternative trading system. The technology vendor should not escape regulation as an ATS.

**Principles of the Consolidation Plan Need More Study**

The Proposal mandates the display of pre-trade information and mandates also that investors have access to the best price available for execution. The second mandatory requirement posits an entitlement on the part of all investors to interact with orders on every system in operation in Canada. Instinet urges that this approach be revisited for the following reasons:

First, the impact of the Proposal on existing ATS operations has to be considered in the context of any technological enhancements the Proposal may require and the cost of those

enhancements and the usual operational difficulties of adapting to somewhat inconsistent regulatory regimes. Instinet and other current and prospective participants in the Canadian markets have already made enormous technology investments and other changes to accommodate US Rule ATS. Additional costs will discourage participation in the Canadian market.

Second, start-up operations should not be exposed to excessive technological barriers to entry.

Third, the existence of a technological means of achieving the consolidation plan is simply taken for granted in the Proposal yet the intended result may not be achievable. U.S. experience in this regard is instructive. While a display rule was implemented for securities quoted on the Nasdaq Stock Market in 1997, Nasdaq already had the necessary technology, SelectNet, in place. A similar display rule for listed equities has never been implemented because exchanges in the United States have been unable to devise a method of accomplishing it.

Fourth, the nature of the technology used by the proposed data consolidator and market integrator has policy implications that are not considered in the Proposal. In the Discussion Paper addressing the consolidation plan, the data consolidator *alone* appears to be responsible for determining the message protocol and the technical specifications of the data feed(s) sent by each system.[5] Any decision on these matters can entail potentially significant financial investment by participating ATSs and can produce significant delays in implementation. The Request for Proposal process should require a consultative process with ATS candidates to ensure that the technological requirements of the data consolidator are the least costly and disruptive achievable.

Fifth, until the technological possibilities are known and the RFP process is complete, the contribution of data to a data consolidator and the market integrator should not be made mandatory but should rather be treated as a proposed feature of the system.

Sixth, the consolidation plan entails radical changes in the way that order flow is handled which have not received as much attention as other aspects of the Proposal such as the much-debated notion of establishing a separate category of registration for ATSs. These radical changes need more debate, are not entirely consistent with Rule ATS and US regulation and include the following specific issues:

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[5] Discussion Paper - "Consolidation Plan for a Consolidated Canadian Market", section III, B.

- **mandatory display of order flow:** There are at least three significant matters to grapple with in this context: (i) what party owns the order, i.e., can an ATS display an order on its own initiative[6] (ii) will forced exposure of order flow on ATSs cause orders to migrate to other jurisdictions and (iii) is an even hand being maintained between ATSs and traditional brokers in the way this change is implemented

- **mandatory access by any party to orders displayed on any ATS:** The Proposal essentially forces all orders to interact which is an unprecedented change in regulation. It is significant that the U.S. approach is more open minded in its approach than the Proposal. In a speech reported on September 24, 1999,[7] the chairman of the Securities and Exchange Commission merely raised the possibility of pulling together all limit orders and internally displayed quotes and called upon the leaders of the securities markets to embark on a consideration of the matter. The Proposal is much more aggressive and does not canvass or even solicits comment on what Chairman Levitt refers to as the "historic conflict between competition and centrality". Even if the objective of the Proposal is to achieve a single limit order book, more input is needed on the technique.

- **linkage with principal markets:** The nature of a "connection" to a principal market is left undeveloped and the case for such a mandatory linkage is not made out.

## *III Specific Comments and Answers to questions posed in Proposal*

**Question 1:**

**ATSs are required to notify securities regulators and to become subject to exchange regulation if they achieve prescribed shares of total trading activity in any ATS**

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6 Consider in this context the Toronto Stock Exchange order exposure rule which contemplates customers being able to instruct on a trade by trade basis that orders *not* be exposed. See TSE Equities Trading Manual at p.1604.

7 See "Excerpt from S.E.C. Chairman's Prepared Remarks" *New York Times*, September 24, 1999 at p.C8.

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

Instinet believes that the 40% volume threshold is an acceptable starting point. Such thresholds are always arbitrary and can have unanticipated consequences and, accordingly, they should be subject to periodic review. The real test of the fairness of the threshold is whether it is applied consistently to market participants. For example, if an entity that was regulated not as an ATS but merely as a broker surpassed the volume threshold, it would seem appropriate to give it the same reporting requirement that would apply to an ATS since its apparent dominance in the trading of a particular security would warrant reconsideration of its regulatory treatment.

A question that deserves additional thought is whether the achievement of the 40% trading volume in a single security is an adequate basis for reclassifying an ATS as an exchange. It may make sense to impose this requirement only when this level of trading penetration is achieved for several securities or many. This is particularly true in Canada where markets tend to be illiquid.

**Question 2:**

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

The comments made concerning consistency of application vis a vis traditional brokers and ATSs in answer to question 1 also apply here. The 5% ceiling in any type of security seems too low and may prematurely and unfairly penalize electronic brokers that are successful.

**Question 3:**

**Is it feasible to require ATSs to calculate the volume threshold when dealing with foreign markets?**

Even if it were feasible as a mechanical matter for ATSs to calculate the volume threshold when dealing with foreign markets, the effect of the rule is to penalize ATSs for their success in

foreign markets by adding their share of trading in those markets to the local share which may be very modest. This does not seem to be a desirable result on policy terms because Canada will presumably want to attract experienced ATSs to its jurisdiction.

**Question 4:**

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

No. Limiting securities that can be traded on an ATS to exchange-traded securities is too restrictive and in effect imposes on ATSs an additional "stock exchange function". The United States Rule ATS places no limitations on the types of securities traded by an ATS and, in this respect, the Proposal is inconsistent with the U.S. approach and needlessly limiting. The prohibition contemplated in this question would mean that Instinet would be unable to trade on behalf of Canadian clients in over the counter stock and "pink sheet stocks" that are not quoted on the Nasdaq Stock Market, securities which Instinet currently trades. The Proposal does not present any justification for regulating categories of ATS securities. This is a matter of fundamental importance because it limits the range of activities of ATSs and undermines the distinction between ATSs and exchanges.

**Question 5:**

**What foreign markets should be included in the Appendix to the Instrument?**

In keeping with the answer to question 4, Instinet believes that there should be no restrictions on the markets in which an ATS can trade securities.

**Question 6:**

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

Instinet is troubled by the reasoning behind the suggested prohibition on principal trading. First, it does not appear to Instinet that such a broad prohibition would achieve the goals articulated in the release. Whether or not dealers elect to withdraw from exchanges, the Proposal will allow them to set up non-member ATSs that compete directly with the exchanges thereby producing the

very evil that the prohibition was designed to avoid. Of equal concern is that the Proposal tilts the playing field in favour of exchanges by giving an incentive to join them, i.e., the ability to trade as principal *and* avoid ATS regulation.

Second, by denying ATSs the right to make an independent business judgment about the securities traded, an ATS is driven to more nearly resemble an exchange than an "alternative" trading system in its function. While an ATS may not engage in proprietary trading now, it may decide as a matter of business practice to engage in such activity at a later time.

**Question 7:**

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

**Question 8:**

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

**Question 9:**

**Are there alternative approaches that should be considered by the CSA?**

Instinet believes these questions are related. The home jurisdiction approach recommended by the Canadian regulators in response to question 7, 8 and 9 is at odds with the statutory scheme of securities regulation across Canada. The approach taken in these jurisdictions is generally that entities trading in a particular jurisdiction should do so in reliance on clear exemptions or else under a licence regardless of how they are registered in the home jurisdiction.

A sensible approach for ATSs that are subject to substantial home jurisdiction regulation would be to have a relatively light form of registration available for ATSs with requirements similar to those in the "international dealer" category of registration in Ontario supplemented by ATS reporting requirements as under the Proposal. This would enable regulators in each province to track the activities of different trading systems, extract a submission to jurisdiction from the ATS operator and have attorneys for service of process and the like. At the same time the registration requirements would not be excessively onerous.

The test proposed in the Proposal for accepting Home Jurisdiction regulation is that the ATS's only contact be with dealers registered in the particular jurisdiction. But once the ATS is in operation, the contacts are bound to be more far-reaching. The ATS will at the very best be indirectly marketed to investors by the dealers with which the ATS deals. Moreover, if the "dealer" is nothing more than a registered conduit conveying order flow directly to an end user via electronic trading or internet trading, it will be difficult to argue that the ATS is not marketing directly or training users directly. Over time, the method of differentiating between Home Jurisdictions recognition of ATSs and ATSs that need direct regulation will become difficult and unworkable.

**Question 10:**

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

**Question 11:**

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

**Question 12:**

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

Instinet consider questions 10, 11 and 12 to be related and would answer each in the affirmative. Instinet agrees with an approach in which the home jurisdiction provides active regulation and thinks this is an acceptable basis for the local Canadian regulator to defer to a foreign regulator. The local form of regulation should be securities regulation for two reasons. First, securities regulation is the most appropriate form of regulation for a securities trading system regardless of how automated it is and second, it is unreasonable to expect Canadian securities regulators to defer to a form of regulation which is not familiar to them. Instinet would suggest, in response to the second part of question 12, that two appropriate jurisdictions would be the United States and the United Kingdom because they have sophisticated securities regulators, important capital markets and have each devoted considerable thought to the appropriate regulation of trading systems.

**Question 13:**

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

**Question 14:**

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

**Question 15:**

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

**Question 16:**

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

Questions 13, 14, 15 and 16 are related and concern order routing and remote access issues. The form of regulation applied to these functions should depend for its comprehensiveness on the relative complexity of the functions. Whether the home jurisdiction is Canadian or foreign should not matter if the local jurisdiction has appropriate rules. If an order routing capability only is in question and the customers are relatively sophisticated, a limited licence such as that of an international dealer may very well be appropriate. Before insisting on membership in a self-regulatory organization, the necessity for a comprehensive form of registration has to be demonstrated. Ontario has an actual record of experience with the international dealer license and, in the absence of a finding that it has been inappropriate, there does not seem to be any need to revisit this matter.

**Question 17:**

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

**Question 18:**

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

This response addresses questions 17 and 18. The whole purpose of recognizing ATSs and of changing their form of regulation to exchange regulation when they become "successful" is that their activities should be less restricted before the relevant success threshold is reached. In particular, all brokers whether traditional or electronic brokers should be able to handle client trading outside the closing bid-ask as long as the information that is drawing the trades outside the closing is publicly available. The fact that stock exchanges in Canada have not gone to 24 hour a day trading should not preclude ATSs from doing so or from functioning when exchanges are closed. Instinet trades 23 hours per day.

For the same reasons, pre-open trading should not be restricted.

**Question 19:**

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

Instinet would answer this question in the negative. A better approach would be to display the best bid and offer and aggregate quantity across all systems contributing data to the data consolidator. This is the approach followed under the CanPX Model for the Canadian market in government debt. Customers should have the authority to regulate the degree to which their orders are made the subject of mandatory display obligations. This should continue. Also, currently on the TSE, the rules applicable to proprietary trading systems allow them not to display orders on the TSE where orders for a minimum of 10,000 shares having a value of not less than $100,000 are involved.

**Question 20:**

**Should an ATS have to contract with the exchange on which a security is listed or should it still be able to choose the exchanges that will perform the market regulation**

**function? This question should be considered from both of the following perspectives: pre-exchange restructuring and post-exchange restructuring.**

**Question 21:**

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

Instinet would answer both questions 20 and 21 in the negative. To avoid conflicts of interest, an ATS should not be compelled to contract for market regulations services from the principal market. It should have a choice. A demonstrably disinterested self-regulatory organization should perform whatever market regulation functions are ultimately decided to be essential for ATSs purposes. Instinet reiterates its concern that the more intrusive market regulatory requirements become the smaller the distinction that will exist between ATSs and Stock Exchanges. ATSs should not regulate their own participants or else they risk losing their distinctiveness.

**Question 22:**

**Should any restrictions be placed upon an ATS when there is a regulatory halt imposed by the market where the security is listed or quoted? Should it matter if a halt is imposed by a recognized quotation and trade reporting system?**

Whatever restrictions are put on an ATS, it should not be put in the position of having to send out messages received from a regulator. Rather, the regulator should have an electronic messaging capability capable of being engaged unilaterally by the regulator that will automatically communicate the appropriate messages to ATS users. The extent of the intervention should be halts for the dissemination of information not halts produced by order imbalances in competing market environments.

## *IV Concluding Remarks*

Instinet believes that the CSA should be commended in its efforts to make Canadian markets more competitive. The CSA has done important work in attempting to arrive at a national regulatory framework to promote competition between different trading venues. The success of the Proposal will, in Instinet's respectful view, hinge largely on the compatibility of the proposed rules with the United States Rule ATS.

We will be pleased to discuss any of the comments in this letter with the Commission or its staff. If we can of further assistance to the Commission in this regard, please do not hesitate to contact the undersigned at (416-368-2211), Paul Merolla, our General Counsel (212-310-7548), Elizabeth Coley, our Associate General Counsel (212-310-7619), or René Sorell of McCarthy Tétrault, our Canadian Counsel (416-601-7947).

Yours very truly,

Joie P. Watts, CFA
Managing Director