

Chapter 6

Request for Comments

6.1.1 Notice of Proposed Amendments to National Instrument 21-101 Marketplace Operation and Companion Policy 21-101CP and National Instrument 23-101 Trading Rules and Companion Policy 23-101CP

NOTICE OF PROPOSED AMENDMENTS TO NATIONAL INSTRUMENT 21-101 MARKETPLACE OPERATION AND COMPANION POLICY 21-101CP

AND

NATIONAL INSTRUMENT 23-101 TRADING RULES AND COMPANION POLICY 23-101CP

I. INTRODUCTION

The Canadian Securities Administrators (the CSA or we) are publishing proposals for comment that would amend National Instrument 21-101 *Marketplace Operation* (NI 21-101), National Instrument 23-101 *Trading Rules* (NI 23-101) and the related companion policies (together, the ATS Rules).

These amendments have been approved for publication in British Columbia, Alberta and Ontario and are being published at this time by only the Ontario Securities Commission. CVMQ staff will submit the proposed amendments to the CVMQ on July 8, 2003. British Columbia, Alberta and, if approved, the CVMQ, will publish the amendments on July 11, 2003. The comment period for all jurisdictions will end on September 11, 2003.

II. BACKGROUND

The purpose of the ATS Rules is to create a framework that permits competition between traditional exchanges and other marketplaces, while ensuring that trading is fair and efficient.¹

The regulatory objectives are

- to provide investor choice as to execution methodologies or types of marketplaces,
- to improve price discovery,
- to decrease execution costs, and
- to improve market integrity

There are three parts to the ATS Rules:

1. a framework that outlines how marketplaces² are authorized to do business and how they are regulated,
2. requirements relating to data transparency and market integration to minimize any negative impact of having multiple markets trading the same securities, and
3. market regulation rules.

The Current Regime

The current requirements in the ATS Rules as of December 1, 2001 (the 2001 ATS Rules) are summarized below.

¹ See Notices for background at (1999), 22 OSCB (ATS Supp), (2000), 23 OSCB (Supp) and (2001), 24 OSCB (Supp).

² Marketplaces are exchanges, quotation and trade reporting systems and alternative trading systems (ATSs).

1. Equity Securities

(i) Transparency

The 2001 ATS Rules set out pre-trade and post-trade requirements for marketplaces that trade exchange-trade securities and foreign exchange-traded securities.³

The CSA postponed implementation of the requirement to provide pre-trade and post-trade information to a data consolidator until December 31, 2003 because of the cost of developing the information processor and the uncertainty with respect to how the market would develop. Consequently, all marketplaces are currently exempt from the requirement to provide information to an information processor provided that the marketplace provides its order and trade information to an information vendor.

(ii) Market Integration

Market integration was designed in two phases.⁴ In Phase 1, each marketplace is required to connect to the marketplace designated as the principal market (the marketplace with the largest trading volume in a particular security for the previous calendar year). Full integration was postponed until after December 31, 2003 because we wanted to see how many new marketplaces developed before making a commitment to a particular solution for integration (creation of a market integrator or requiring each marketplace to connect to each other). Marketplaces are currently subject to the Phase 1 requirements and are complying either directly or indirectly.

(iii) Market Regulation

All marketplaces are required to enter into a contract with a regulation services provider (RSP). The subscribers of the marketplace are required to agree to be bound by the requirements of the RSP.⁵ For equity securities, the RSP is Market Regulation Services Inc. (RS Inc.) and the ATs and their subscribers are required to comply with the rules of the RS Inc. – the Universal Market Integrity Rules (UMI Rules).

2. Government Debt Securities and Corporate Debt Securities

(i) Transparency

Marketplaces and inter-dealer bond brokers are required to provide order and trade information on designated benchmark government debt securities to an information processor in real-time.

For corporate debt securities, marketplaces are required to provide order information to an information processor. In addition, marketplaces, inter-dealer bond brokers, and dealers executing trades outside of a marketplace are required to provide to an information processor trade information regarding corporate debt securities within one hour of the trade, subject to volume caps of \$2 million for investment grade corporate debt securities and \$200,000 for non-investment grade corporate debt securities.⁶ The existing ATs executing trades of fixed income securities have been exempted from the pre-trade and post-trade transparency requirements until December 31, 2003. In addition, the CSA have not designated an information processor and therefore, the information currently being provided to CanPX is being done voluntarily.

(ii) Market Integration

Because the existing fixed income ATs have received exemptions from the transparency requirements, and because we have not completed the designation of CanPX as the information processor, market integration for marketplaces trading fixed income securities does not apply.⁷

(iii) Market Regulation

In the 2001 ATS Rules, we provided an exemption for all marketplaces executing trades of fixed income securities, inter-dealer bond brokers and dealers executing trades of corporate debt securities from the requirement to enter into a contract with an

³ NI 21-101, Part 7.

⁴ NI 21-101, Part 9.

⁵ NI 23-101, Part 8.

⁶ NI 21-101, Part 8 and Companion Policy 21-101CP, Part 10.

⁷ NI 21-101, Part 9.

RSP provided that they comply with IDA Policy No. 5 Member Firms Trading in Domestic Debt Markets, as amended (IDA Policy No. 5).⁸

III. SUBSTANCE AND PURPOSE OF THE PROPOSED AMENDMENTS

Over the last 18 months, CSA staff have been working on the following initiatives:

- set up an industry committee to look at data consolidation and market integration for the equity markets;
- worked with the IDA to hire a consultant to survey market participants regarding the market integrity issues in the fixed income market and conduct a follow-up examination of some of the dealers;
- established and met with the Bond Market Transparency Committee to look at the appropriate levels of transparency for government debt securities and corporate debt securities; and
- working with the self-regulatory organizations⁹ (SROs) to develop a process for implementing the requirement for an electronic audit trail.

The proposed amendments to the ATS Rules (the Proposed Amendments), which are attached and summarized below, are the results of these initiatives.

(a) Data Consolidation and Market Integration for Equity Securities

The CSA struck an industry committee to look at data consolidation and market integration for the equity markets (the Industry Committee). The Industry Committee was chaired by Gerry Rocchi of Barclays Global Investors Canada and we want to extend our thanks and appreciation to Mr. Rocchi for his work and leadership in chairing the committee. The members of the Industry Committee consisted of representatives from marketplaces, investors, dealers and regulators. The Industry Committee examined whether there was a need for a data consolidator and market integrator for equity securities.

The Industry Committee issued a report on March 7, 2003, which is attached to this Notice as "Appendix A". The Industry Committee recommended that the CSA replace the data consolidation requirements with the establishment of certain technology standards that will enable RS Inc. to get the data it needs to conduct surveillance of market activity. These standards will be established by RS Inc., in consultation with the industry and will be approved by the CSA. They also recommended that there be no requirement for a market integrator, instead the regulators will rely on best execution and fair access requirements to achieve the same result.

We intend to implement the Committee's recommendations by:

- (i) establishing a standards committee made up of representatives of industry participants to determine the standards to be applicable to marketplaces trading equity securities¹⁰; and
- (ii) amending the rules to reflect the recommendations. Specifically, we
 - (1) will allow information on orders and trades to be sent to an information vendor that meets the standards set by a regulation services provider (RS Inc.),¹¹
 - (2) have deleted the concept of "market integrator"¹² and will focus on ensuring compliance with best execution requirements for dealers and fair access requirements for marketplaces.¹³

⁸ NI 23-101, sections 8.5, 9.3 and 10.3.

⁹ The SROs working with the CSA are the IDA, RS Inc., Bourse de Montréal, and the Mutual Fund Dealers Association of Canada.

¹⁰ Proposed Amendments to Companion Policy 21-101CP, subsection 1.1(8) regarding Part 9.

¹¹ Proposed Amendments to NI 21-101, subsection 1.1(5) regarding Part 7.

¹² Proposed Amendments to NI 21-101, subsection 1.1(2) regarding section 1.1.

¹³ NI 21-101, existing section 5.1, NI 23-101, existing section 3.1 and Proposed Amendments to NI 21-101, paragraph 1.1(4)(b) regarding the addition of section 6.13.

During the discussions of the Industry Committee, it became clear that there is a need for more study as to the appropriate level of transparency for options. Consequently, the CSA have provided an exemption from the transparency requirements for 3 years with respect to options.¹⁴

(b) Changes Regarding Market Regulation for Fixed Income Securities

The CSA and IDA retained Deloitte & Touche to conduct a survey of market participants. The survey asked market participants whether they thought the current regulation of the debt market was sufficient and asked them to identify problems or issues in the trading practices of participants in the fixed income market. The report prepared by Deloitte & Touche was published on December 13, 2002¹⁵ (the Deloitte & Touche Report). Based on the findings of that report, the IDA, with input from CSA staff, developed and conducted an examination of the dealers to look at the issues raised in the Deloitte & Touche Report and to determine whether the dealers were complying with IDA Policy No. 5 and other requirements related to trading debt securities.

The purpose of interviewing market participants regarding the market integrity issues in the fixed income market and the follow-up examination sweep of some of the dealers was to see if there is a need for new rules or a different way of monitoring the fixed income markets. As a result of the IDA review, the CSA are of the view that there is currently no need to add any rules relating to market integrity for the fixed income markets. The issues that have been identified by the IDA examinations include a lack of clarity surrounding the requirements in IDA Policy No. 5 and a need for more detailed policies and procedures at some of the member firms. In any case, it is our current view that these issues and any follow-up items can be dealt with through the IDA as the regulator of dealers and ATSS. Consequently, the CSA are of the view that at the current time, it is appropriate for the IDA to act as an RSP for debt market participants.¹⁶ We note that the inter-dealer bond brokers have been exempted from the requirement to contract with an RSP provided that they comply with IDA Policy No. 5.¹⁷

(c) Data Consolidation for Government Debt Securities

In December 2001, the CSA struck a committee to provide guidance on issues related to the fixed income market. The Bond Market Transparency Committee (BMT) consists of two representatives from each of the buy side, sell side, inter-dealer bond brokers, government issuers, regulators and a representative of each of CanPX and an ATS.

Much of the discussion of the BMT focused on the appropriate level of transparency for government debt securities and corporate debt securities. While there appears to be consensus regarding the level of transparency for corporate debt securities, there are still differing views on the appropriate level of transparency for government debt securities. Some BMT members believe there should be full transparency for inter-dealer bond brokers and systems that are anonymous auction markets. Others believe that all marketplaces and IDBs should be subject to the same transparency requirements no matter what type of execution methodology is used. Some believe that new entrants should be exempt from the transparency requirements until they develop their business, but others believe that this unfairly disadvantages existing participants.

Although the CSA are committed to gradually increasing transparency, we believe that it is premature to impose transparency requirements in the government debt market. In our view, the market should determine the appropriate level of transparency. Consequently, we have granted all participants an exemption from providing order and trade information regarding government debt securities to an information processor for three years.¹⁸ In Companion Policy 21-101CP, we have outlined our view regarding where the initial transparency requirements may be at the end of the three-year period.¹⁹ From the time of the implementation of these amendments until the expiration of the exemption, the CSA will continue to discuss with the industry the appropriate transparency levels for government debt securities and corporate debt securities and monitor how the market develops. If the levels in Companion Policy 21-101CP are inappropriate or it is determined that the model for transparency should be similar to the equity model (standards), NI 21-101 and the related Companion Policy will be amended accordingly.

Specific Request for Comment

The CSA wish to seek comment on whether to maintain the status quo for three years by granting an exemption from the transparency requirements for government debt securities or require that IDBs and all marketplaces provide post-trade

¹⁴ Proposed Amendments to NI 21-101, section 1.1(5) regarding section 7.5.

¹⁵ (2002), 25 OSCB 8341.

¹⁶ Proposed Amendments to Companion Policy 23-101CP, paragraph 1.1(3)(b) regarding the addition of section 7.5.

¹⁷ Proposed Amendments to NI 23-101, subsection 1.1(4) regarding the deletion of subsection 9.3(2) and Proposed Amendment to Companion Policy 23-101CP, paragraph 1.1(3)(a) regarding section 7.3.

¹⁸ Proposed Amendments to NI 21-101, subsection 1.1(6) regarding section 8.3.

¹⁹ Proposed Amendments to Companion Policy 21-101CP, subsection 1.1(9) regarding section 10.1.

information regarding government debt securities to the information processor subject to volume caps and on a fully anonymous basis (no name of subscriber or marketplace).

(d) Data Consolidation for Corporate Debt Securities

The requirements with respect to the corporate debt securities will be maintained. Marketplaces, inter-dealer bond brokers and dealers will have to provide post-trade information regarding designated corporate debt securities to an information processor, subject to volume caps.²⁰

To that end, we will recommend that each Commission find that it is not contrary to the public interest for CanPX to act as an information processor for corporate debt securities under National Instrument 21-101 *Marketplace Operation* for a period of three years.²¹ Once each Commission makes a decision regarding CanPX, we will notify CanPX by letter and publish that letter informing the public of the decision. During the three-year period, staff will analyze, both whether it is appropriate to maintain the information processor model of transparency or to move to the model adopted in the equity market and whether the level of transparency imposed is appropriate.

(e) Market Integration for Debt Securities

We have adopted the same model as on the equity side. We will remove the “market integrator” concept and focus on ensuring compliance with best execution and fair access requirements.

(f) Electronic Audit Trail Requirements

The electronic audit trail requirements for all dealers are set out in Part 11 of NI 23-101. The implementation date of December 31, 2003 was selected to be consistent with the implementation of T+1 which at that time was June 2004. However, because of the delay in implementation of T+1 and the resources and changes necessary to implement an electronic audit trail, we have delayed implementation.

The CSA and SROs published a notice on March 28, 2003²², which stated that over the next few months:

- RS and the Bourse will determine what data must be transmitted to the RSP,
- an industry committee will be struck to determine if there is a need to have common technology standards,
- the SROs will survey dealers to determine their readiness for an electronic audit trail; and
- the CSA and SROs will provide a detailed transition plan.

We have delayed the implementation of the electronic audit trail requirements until the earlier of January 1, 2007 and the date upon which an SRO or RSP implements an electronic audit trail requirement.²³

(g) Other Amendments

There are a number of other amendments that we have made to the ATS Rules. Most of them are being made to clarify the existing provisions. They are summarized below:

1. NI 21-101

- amendment to Part 10 regarding the disclosure of transaction fees to reflect the changes to data consolidation²⁴

²⁰ Proposed Amendments to NI 21-101, subsection 1.1(6) regarding Part 8 and Proposed Amendments to Companion Policy 21-101CP, subsection 1.1(9) regarding section 10.1.

²¹ This language reflects section 16.2 of Companion Policy 21-101CP.

²² (2003), 26 OSCB 2461.

²³ Proposed Amendment to NI 23-101, paragraph 1.1(6)(h) regarding subsection 11.2(6).

²⁴ Proposed Amendment to NI 21-101, subsection 1.1(8) regarding Part 10.

- deletion of the requirement for a marketplace to keep the client identifier or account information, variation, correction or cancellation information from a client and client instructions or consents regarding order handling.²⁵ These provisions are unnecessary because the dealer maintains this information.

2. Forms 21-101F1, 21-101F2, 21-101F3, 21-101F4, 21-101F5 and 21-101F6

- amendment to the forms to reflect CSA Notice 21-302²⁶, published on January 24, 2003 that indicates that the CSA intends to keep all forms confidential²⁷

3. Companion Policy 21-101CP

- clarification that a marketplace is an exchange, quotation and trade reporting system or an ATS²⁸
- notification that marketplaces should use publicly available information to calculate the thresholds in section 6.7 of the Instrument²⁹
- amendment of the policy to conform to CSA Notice 21-302³⁰ published on January 24, 2003 that indicates that the CSA intends to keep all forms confidential³¹

4. NI 23-101

- clarification that persons or companies are exempt from certain provisions of NI 23-101 if they comply with similar requirements of an RSP³²
- clarification that the subscriber is subject to the orders or directions made by the regulation services provider in its capacity as the regulation services provider for the ATS³³
- addition of an insider marker to correspond with the requirements of RS Inc.³⁴
- clarification that the record kept in Part 11 may be transmitted to the securities regulatory authority upon request³⁵

5. Companion Policy 23-101CP

- clarification that persons or companies are exempt from certain provisions of NI 23-101 if they comply with similar requirements of an RSP³⁶

IV. COMMENTS AND QUESTIONS

We invite all interested parties to make written submissions with respect to the Proposed Amendments. Submissions received by September 11, 2003 will be considered.

²⁵ Proposed Amendments to NI 21-101, subsection 1.1(9) regarding Part 11.

²⁶ (2003), 26 OSCB 523.

²⁷ Proposed Amendments to Forms 21-101F1, 21-101F2, 21-101F3, 21-101F4, 21-101F5 and 21-101F6, section 1.1.

²⁸ Proposed Amendments to Companion Policy 21-101CP, subsection 1.1(2) regarding section 2.1.

²⁹ Proposed Amendments to Companion Policy 21-101CP, subsection 1.1(3) regarding subsection 3.4(7).

³⁰ (2003), 26 OSCB 523.

³¹ Proposed Amendments to Companion Policy 21-101CP, subsection 1.1(5) regarding subsection 6.1(2).

³² Proposed Amendments to NI 23-101, subsection 1.1(2) regarding section 2.1.

³³ Proposed Amendments to NI 23-101, paragraph 1.1(3)(a) regarding subsection 8.4(c).

³⁴ Proposed Amendments to NI 23-101, paragraph 1.1(6)(c) regarding Part 11.

³⁵ Proposed Amendments to NI 23-101, paragraphs 1.1(6)(d), (e) and (g) regarding Part 11.

³⁶ Proposed Amendments to Companion Policy 23-101CP, subsection 1.1(2) regarding section 2.1.

Request for Comments

You should send submissions to all of the CSA listed below in care of the OSC, in duplicate, as indicated below:

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

c/o John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
Suite 1900, Box 55
Toronto, Ontario M5H 3S8
E-mail: jstevenson@osc.gov.on.ca

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

Denise Brosseau,
Secretary
Commission des valeurs mobilières du Québec
800 Victoria Square, Stock Exchange Tower
P.O. Box 246, 22nd Floor
Montréal, Québec H4Z 1G3
Telephone: 514-940-2150
Fax: 514-864-6381
e-mail: consultation-en-cours@cvmq.com

If you are not sending your comments by e-mail, please send us two copies of your letter, together with a diskette containing your comments (in either Word or WordPerfect format).

We cannot maintain confidentiality of submissions because securities legislation in certain provinces requires us to publish a summary of written comments received during the comment period.

Questions may be referred to any of:

Veronica Armstrong
Senior Policy Advisor, Legal and Market Initiatives
British Columbia Securities Commission
Phone: (604) 899-6738
E-mail: varmstrong@bcsc.bc.ca

Glenda Campbell
Vice-Chair
Alberta Securities Commission
Phone: (403) 297-4230
E-mail: Glenda.Campbell@seccom.ab.ca

Randee Pavalow
Director, Capital Markets
Ontario Securities Commission
Phone: (416) 593-8257
E-mail: rpavalow@osc.gov.on.ca

Request for Comments

Tracey Stern
Senior Legal Counsel, Market Regulation
Ontario Securities Commission
Phone: (416) 593-8167
E-mail: tstern@osc.gov.on.ca

Ann Leduc
Chef du service de la réglementation
Commission des valeurs mobilières du Québec
Phone: (514) 940-2199 ext. 4572
E-mail: ann.Leduc@cvmq.com

Serge Boisvert
Conseiller en réglementation
Commission des valeurs mobilières du Québec
Phone: (514) 940-2199 ext. 4576
E-mail: serge.boisvert@cvmq.com

APPENDIX A

REPORT TO THE CANADIAN SECURITIES ADMINISTRATORS MARKET STRUCTURES COMMITTEE

INDUSTRY COMMITTEE ON DATA CONSOLIDATION AND MARKET INTEGRATION IN CANADA

MARCH 7, 2003

Executive Summary

The Industry Committee on Data Consolidation and Market Integration is pleased to submit its report to the Canadian Securities Administrators (CSA) Market Structures Committee.

The Committee found strong support for a market-driven solution to the issues of data consolidation and market integration in an environment of multiple equity security marketplaces. In the views of the Committee, a market-driven solution, augmented by clarification of best execution obligations, development of common standards on data consolidation, and unrestricted opportunity for connectivity between marketplaces, offers the most efficient, flexible and effective choice available to Canada today. The proposed market-driven principles facilitate the development of competitive and innovative alternative marketplaces in Canada that are also consistent with market integrity and investor protection requirements. It is the recommendation of this Committee that the CSA facilitate this solution with the following actions:

1. Adopt the principles expressed in this report.
2. Participate in the development of minimum standards for market data feeds.
3. Develop and publish additional clarification of the meaning of best execution.
4. Amend National Instrument 21-101, along with related Rules and Companion Policies, that deal with data consolidation and market integration, to conform with the enclosed recommendations.

The members of the Committee are available to answer any questions you may have.

Background

In order to accommodate the entrance of new marketplaces in Canada while maintaining leadership in the global capital markets in terms of efficiency and integrity, the CSA has established appropriate rules and policies to help manage this environment. Most recently, the CSA announced the Marketplace Operations rules which came into force on December 1, 2001, under the Securities Act Rules for The Regulation of Marketplaces and Trading (National Instrument 21-101 and related Rules and Companion Policies).

Fundamentally, NI 21-101 (also known as the "ATS Rules"), along with the related companion policy 21-101CP, set out a phased approach to data consolidation and market integration. The Instrument also outlined other elements including clarification on the best execution obligations of market participants, a short selling rule and other measures.

Both data consolidation (of pre- and post-trade data) and market integration were determined in the regime to be an integral part of the facilitation of multiple marketplaces in Canada, which would otherwise lead to certain fragmentation problems.

The concept of market integration was proposed to provide a mechanism to ensure that orders received best execution. Market integration was to be accomplished by requiring all marketplaces to connect to and abide by the terms of a "market integrator" or to connect to all other marketplaces in the absence of a market integrator. In the interim, each marketplace was to connect to the principal exchange for a security. It was originally presumed that all marketplaces in some manner must eventually be linked to each other and have the ability to route orders to each other to obtain best execution and to avoid locked and crossed markets.

Data consolidation in turn was prescribed as a necessary precursor to facilitating effective best execution and for ensuring market integrity. Data consolidation was to be accomplished by requiring all marketplaces to provide pre- and post-trade data to an "Information Processor" by January 1, 2004. The Information Processor concept was specifically defined in the ATS Rules and it was intended that this entity would disseminate one consolidated feed to the market. In the interim, all marketplaces were to provide data to an information vendor.

Although data consolidation and market integration are separate ideas, they are related in that they are geared to addressing public policy concerns with market fragmentation.

Subsequent to the publication of the ATS Rules in late 2001, there has been feedback regarding possible alternatives to mandating market integration and data consolidation. In addition, the ATS market structure together with the Universal Market Integrity Rules ("UMIR") and an independent equity market regulator, Market Regulation Services Inc. ("RS") have been fully implemented. However, there is no sanctioned data consolidation system in place, nor any market integration. In advance of the deadline in NI 21-101, the CSA must establish a review process designed to determine the best methods for moving forward on a Data Consolidation system.

The Industry Committee on Data Consolidation and Market Integration was formed to advise the CSA on the best methods for moving forward, and committed to reporting on the following questions:

1. Is data consolidation and market integration necessary in the Canadian market?
2. What are the solutions?
3. Can the market provide the solutions?
4. What are the barriers to the market providing the solutions (costs, systems, etc.)?
5. Who will bear the cost of the solution?
6. What should regulators and market participants do to facilitate the implementation of the solution?

Process

The Committee was formed with representation from key constituents from the Canadian capital market. The Committee was composed of market participants, exchanges, alternative trading systems, data providers, and RS. CSA members also participated in the discussions.

The Committee agreed to an expeditious process. Four meetings were held to address the questions. The initial meeting was used to establish all the key issues. The second and third meetings required research to be prepared by participants. The final meeting was used to obtain an overall agreement on the key issues and what was the best model for moving forward. Minutes were prepared for all meetings.

The Committee focussed on a number of key issues including whether a market solution is possible in any particular area and what regulatory requirements might be required to accommodate a flexible market approach. They discussed what actions must be taken to make a market-based solution effective. The participants also discussed what areas required further examination outside of the mandate of the Committee.

The following section outlines the key recommendations of the Committee.

Recommendation Summary for Cash Markets

The Committee decided to contain the scope of discussions to address current realities in Canada. These key assumptions provided the context for the recommendations:

- a) The recommendations must be relevant to marketplaces that trade Canadian equities; and
- b) The recommendations must apply to marketplaces that offer execution on the same securities

It was determined by the Committee that a mandated centralization of market integration and data consolidation is unnecessary to ensure the continued integrity of Canadian capital markets. Nonetheless, it was deemed imperative that market integrity and best execution principles be key considerations in developing the proposed recommendations. Also, market solutions must ensure that market efficiency and efficacy be fostered and costs to the Canadian industry be mitigated.

In this context, it was determined that existing industry technology capabilities and relationships could adequately accommodate market integration and data consolidation requirements and current industry synergies should be utilized. It was felt that this paradigm would foster market innovation and competitiveness and justify costs based on commercially viable means.

Based on the analysis and opinions expressed by the Committee, the recommendations were made in the following key areas:

- 1) Market Driven – Data consolidation and market integration should be achieved largely via a principles-based approach, using market-driven implementation.

- 2) Market Integration - There should be no mandated market integration, however, data consolidation is required to ensure best execution. The CSA, with RS input, needs to further define best execution and what constitutes a Canadian trade.
- 3) Data consolidation – This is required but should not be centralized. An open standards approach should be pursued. A task force should be assigned to define the specifications for a consolidated feed and to establish standards.
- 4) Market Integrity - RS needs to further define how UMIR will evolve, given the proposed paradigm.

Individual Recommendations for Cash Markets

1. Market Driven

The Committee determined that market driven solutions appear to be a fair and reasonable course of action to accommodate the divergent interests of the trading community at large.

Consolidation of marketplace data should have a standardized format but its use should be open to a variety of business and commercial applications. Mandating the centralization of this function was not recommended. However, the wide availability of consolidated data was identified as important to the overall marketplace.

In terms of market integration, any prescribed market integration was assessed to run the risk of being overly restrictive and inflexible to changes in the market (these changes include technology, marketplace models, trading strategies etc.). It was acknowledged that Canada's market structures already experience less fragmentation than in the U.S. It was determined that access and order management vendors in Canada and the U.S. currently offer a full range of options to manage order flow generated from Canada. Options range from fully automated smart order routing to manual selection of destinations by traders on their desktop terminals. Buy and sell side traders can choose from many technology providers to access any marketplace. Competitive forces provide comprehensive and cost effective solutions today. Best execution rules and market supply and demand should determine the means by which traders access a particular marketplace. Again, traders and firms should make best market determinations freely and have the option to choose how best to manage this process.

In short, market forces have solved the issue of connectivity. Regulation should therefore focus on the rules of the marketplace, rather than how different market centers would connect between and among themselves.

Any market driven solutions should be simple, efficient, low cost, flexible and address interoperability concerns.

2. Market Integration

The Committee determined that mandated market integration is not required to ensure market integrity in an environment where adequate data consolidation of pre- and post-trade data is available to market participants.

It was deemed that this approach would encourage utilizing existing industry capabilities and relationships and would also foster a cost effective and commercially viable solution. This approach also relies on market participants being responsible for best execution. The best execution obligation of market participants should ensure market integrity in instances where direct market integration would have otherwise provided it.

This does not imply that marketplace should or would not connect to one another if there are compelling reasons to do so. In fact, the Committee encouraged open standards so that no marketplace should be restrictive in their access criteria or limit the ability of another marketplace to connect to them for reasons that are anti-competitive. It was also expressed that exceptions may arise where there are objective commercial reasons or liability concerns. Marketplaces should however, be allowed to charge connectivity fees to other marketplaces in the same manner as they would other access participants. Failure to pay fees and lack of credit worthiness are reasons to terminate/prevent access to participants.

The Committee determined that best execution decisions should be the purview of brokers and investors as long as these decisions comply with UMIR. Brokers and investors currently make the decision on how to manage and direct order flow. With additional marketplaces in Canada, this behaviour should be no different. This is currently the case with inter-listed stocks whereby brokers and investors may direct order flow to either a Canadian or a U.S. exchange.

In a practical manner, brokers and vendors can accommodate best execution criteria. However, best execution requires marketplace access. Business drivers and correspondent relationships will drive and facilitate early access. Decisions for access will have to take into account a marketplace's business model, participant demand, liquidity, and risk of transacting on the marketplace. The Committee recommends that marketplaces be required to give access to other marketplaces that seek it, on reasonable terms, but that marketplaces should not be forced to connect to other marketplaces.

It was also determined that best execution needs to be further defined to address a variety of criteria under the proposed model. The required further definition is likely to be focussed on the order-routing practices and other processes of market participants that provide assurance that the overall processes of participants are designed to provide best execution. This is particularly true because the processes of market participants in ensuring best execution effectively replaces the “system-enforced” execution of market integration. It was also understood that current access vendors would be able to facilitate best execution on behalf of market participants using consolidated displays and direct marketplace access via their desktop terminals. Access vendors and order management systems currently exist in Canada to address order routing based on a variety of best execution attributes.

Traders and investors also currently may choose which market to trade an inter-listed equity security based on price, volume, market impact, currency shifts, or other factors. Trading strategies may also play into whether one trader will use an order management system, choose one market over another or both etc. An arbitrage trader will use different best execution criteria than a portfolio manager. The key issue is choice. Market driven solutions will offer this choice. Further, additional clarity on best execution expectations of participant processes will facilitate the provision of this choice.

The CSA in consultation with RS will undertake to define the standards for best execution given the Committee’s proposed recommendations. These parties have also committed to define what constitutes a “Canadian Trade” (this definition should include where the security traded, what is an eligible security, parties to the trade etc.).

3. *Data Consolidation*

As discussed, adequate data consolidation of pre and post trade data available to market participants is required to facilitate best execution and market integrity. The Committee determined that this can be provided without a costly mandated/centralized approach and that market driven, commercially viable options exist.

With the exception of special types of orders, pre- and post-trade data consolidation is necessary in Canada amongst marketplaces offering execution on the same securities. Data consolidation does not, in and of itself, interfere with the potentially competing needs in the market for transparency and anonymity. In the view of RS, order information (pre-trade consolidation) for marketplaces that do not operate as auction markets is necessary to facilitate a market participant’s compliance with best execution obligations. Pre-trade consolidation may not be necessary where a market only handles special types of trades such as Call Market Orders, Special Terms Orders, Market-on-Close Orders and Volume-Weighted Average Price Orders, which order types are currently recognized in UMIR. Appropriate additional provisions and exemptions should be added to UMIR to accommodate future products and facilities introduced by marketplaces.

Fundamentally, the key objectives of data consolidation are to:

- Provide visibility and transparency to all key stakeholders of continuous marketplaces’ pre and post trade information;
- Facilitate best execution while allowing flexible trading methodologies;
- Facilitate effective market regulation and market integrity;
- Minimize additional costs to the investment community;
- Allow key stakeholders to utilize existing technology capabilities and commercial relationships.

To adequately address these objectives the Committee recommended an open standards based model for consolidating data. It was deemed that data consolidation can be provided in a cost-effective, flexible, efficient and competitive manner by the market under a standards-based framework. The proposed framework outlines a model whereby a consolidated feed specification be developed that can be used by market participants for best execution purposes and for RS to perform market surveillance and regulation. The objective of the consolidated feed is to standardize content and messaging to mitigate fragmentation issues that disparate messaging protocols may create. Multiple vendors and marketplaces could use and distribute the consolidated feed however, each marketplace would be required to send their pre and post trade data to RS in the consolidated format for market regulation purposes only and not for redistribution by RS. Standards within the feed would be used to facilitate best execution and to address market integrity concerns.

The feed protocol should consider emerging global standards to lower barriers to entry, ensure the potential for cost effective integration of market innovations, and ensure Canadian participants are neither disadvantaged by the requirement to support regional disparities, nor unduly burdened with any costs of conversion. The emerging open trading standard is FIX, being evolved by the industry to manage the full life cycle of a trade, and used in Canada today in some form by every access vendor. This would not preclude the use of the STAMP protocol currently deployed by Canada’s primary markets for trade execution and data dissemination. The choice would need to necessarily balance the comparative utility of FIX and the short-term cost of conversion by current users with the probability of eventual conversion to FIX by all users and the interim requirement to

maintain multiple protocols to satisfy all needs. There would be little risk of a failure of demand and supply for the consolidated feed and evolving requirements and technology place an advantage on a flexible, market-based solution.

The Committee also discussed what the standards should be and how RS would use the consolidated feed to adequately perform market regulation functions. It was concluded that data consolidation in a market-based setting requires the establishment of standards such as timestamps, connectivity, communication protocols, reference data, reporting, content, etc. The Committee recommends that these standards should be developed and published by RS, in consultation with industry and regulatory participants. To this end, the Committee recommends that a task force be initiated and deliberations should commence as soon as is practical. Once launched, RS may certify all entities that distribute the consolidated feed.

In addition to establishing standards and defining details for the consolidated feed, it was concluded that additional data consolidation details are also required to address best execution and market integrity issues. In particular, it was identified that there may need to be mechanisms to account for fragmentation concerns arising from physically dislocated marketplaces and the latency issues inherent in this paradigm as it relates to matters such as trade-throughs, short sales, front running, and locked and crossed markets. It may not be possible to remove latency but practical measures may be applied to quantify the latency and its impact. Some level of tolerance may need to be applied by RS in respect of latency (this will be discussed further under the Market Integrity section). The task force will be charged with identifying appropriate standards that can help manage these issues.

With the timely development of appropriate standards, market-based data consolidation solutions are likely to be available at or shortly after January 1, 2004.

The Committee also noted that a market-based solution requires that entities distributing consolidated feeds be informed of new marketplace applicants and there should be a requirement that marketplace applicants demonstrate arrangements with at least one such entity prior to receiving recognition as an exchange or registration as an ATS.

4. *Market Integrity*

As indicated, given the proposed recommendations RS will need to contemplate the manner in which it can effectively regulate the market and adequately monitor compliance with UMIR.

The task force, in conjunction with RS, will provide the standards by which to compare marketplace transactions in the context of best execution and market integrity considerations. RS will in turn need to define how to use the consolidated data and standards to manage inherent market fragmentation issues in an operational context. Although the proposed consolidated feed model will give RS the necessary data to do this, additional consideration needs to be given to how best to address managing trade-throughs, short sales, front running, locked and crossed markets, and other situations, including any possible amendments to UMIR. RS may need to develop additional tools to properly utilize the consolidated feed, and will need to consider how the related costs are shared.

RS will also need to consider latency issues between marketplaces and may need to develop its position on latency when monitoring transactions for compliance with UMIR. In particular, latency issues may arise for transactions that depend on the last sale price such as short sales.

Committee Members noted that market forces and arbitragers should be able to address locked and crossed market situations, with possible exceptions for new marketplaces which have yet to achieve adequate vendor and trader penetration. The continuation of a requirement for the non-principal marketplace to connect to the principal marketplace may also address this issue.

Recommendations for Derivatives Markets

The Montreal Exchange has asserted that data consolidation is not required for ATSS offering trading in options, as options are not fungible between clearing organizations. This involves situations with bundling of execution and clearing services, and raises questions as to the meaning of best execution for options in such an environment. Moreover, the options market is less mature than the cash markets. Reflecting the uncertainty caused by these elements, it is proposed to allow a two-year transition period and to review the matter at that time.

APPENDIX 1

Committee Members

Chair	Gerry Rocchi	Barclays Global Investors Canada
Investors	Morgan McCague	Ontario Teachers' Pension Plan Board
Dealers	Jim Mountain	Scotia Capital
	Ray Tucker	TD Newcrest Inc.
Data Vendors	Kirsti Suutari	Reuters Canada Ltd.
	Marc Gunter	E*TRADE Technologies Corporation
Regulators	Tom Atkinson	Market Regulation Services Inc.
	Noelle Wood	Market Regulation Services Inc.
Markets	Richard Nesbitt	TSX Markets
	Bruce Garland	Bloomberg Tradebook
	Joe Lombard	Archipelago Canada
	Luc Bertrand	Bourse de Montréal Inc.
Technology	John Cieslak	TSX IT&T
CSA Contacts	Randee Pavalow	Ontario Securities Commission
	Tracey Stern	Ontario Securities Commission
	Ann Leduc	Commission des valeurs mobilières du Québec
	Yves Cloutier	Commission des valeurs mobilières du Québec