

1.1.2 OSC Staff Notice 21-706 – Marketplaces' Initial Operations and Material System Changes

OSC STAFF NOTICE 21-706 – MARKETPLACES' INITIAL OPERATIONS AND MATERIAL SYSTEM CHANGES

I. Background

OSC Staff (Staff) have been examining the regulatory requirements for recognized exchanges (Exchanges) and alternative trading systems (ATs) set out in National Instrument 21-101 *Marketplace Operation* (NI 21-101) and in National Instrument 23-101 *Trading Rules* (together, the Marketplace Rules). We have also been reviewing the practices set out around those requirements in various recognition orders, rule protocols and staff practices. The purpose of our review was to update and, where appropriate, to align the regulatory requirements and processes for review of new operations and changes to the operations of Exchanges and ATs.

As a first step, we issued OSC Staff Notice 21-703 – *Transparency of the Operations of Stock Exchanges and Alternative Trading Systems* (OSC Staff Notice 21-703), where we described Staff's process for reviewing the initial filings for Exchanges and ATs and changes to certain of their operations. In that notice, we also set out our expectation that Exchanges and ATs maintain an appropriate degree of transparency for certain aspects of their operations to ensure that investors and market participants are better informed as to how securities trade on these marketplaces. We described the types of information that marketplaces should publish in order to obtain feedback from other market participants regarding certain proposed changes to marketplace operations, and to increase transparency of marketplace features and operations. We also described the process for publication and Staff review.

The next phase of our examination was a review of the regulatory requirements set out in the Marketplace Rules in order to streamline and update them and to increase consistency, where appropriate, between the requirements applicable to Exchanges and to ATs. We made a number of revisions to the Marketplace Rules (the Amendments) that came into force on July 1, 2012. In addition to the objectives outlined above, the Amendments also aim to increase the transparency of the operations of marketplaces. For example, a marketplace must disclose on its website information regarding its operations including fees, a description of its order types and how these orders interact, and access requirements.

II. Purpose of this notice

This notice sets out Staff's process to review the initial filings of entities applying to be recognized as Exchanges by the Commission and those applying to be registered as ATs. The notice also sets out Staff's expectations regarding the timing of a marketplace's commencement of operations and the timing of the implementation of material systems changes. This notice incorporates and updates the content of OSC Staff Notice 21-703 and replaces that notice. The processes for filing, publication, review and approval of changes in marketplace operations, previously documented in OSC Staff Notice 21-703, have been set out in the Marketplace Rules and in each marketplace's protocol for reviewing rules or changes to the marketplace's operations (the Marketplace Protocols).

III. Review of initial operations

(a) Exchanges

An applicant that seeks to carry on business as an Exchange in Ontario must file an application for recognition under section 21 of the *Securities Act* (Ontario) (Application). The Application must include a description of the operations of the Exchange and how the Exchange would meet the provisions of NI 21-101 and certain recognition criteria such as governance, fees, access, regulation of products and participants, rulemaking, clearing and settlement, and systems and technology. The rules of the Exchange also form part of the Application and often describe the order types and structure of the Exchange. As part of the process, an applicant for recognition as an Exchange must also file Form 21-101F1 *Information Statement Exchange or Quotation and Trade Reporting System* (F1).¹ The F1 contains detailed information about many of the aspects described in the Application, and is confidential as it contains proprietary financial, commercial and technical information.

The Application, along with the Exchange's rules, policies and a draft recognition order are published for a 30-day comment period in the OSC Bulletin and on the OSC website. Once all the issues raised during the comment process and Staff's own review of the application materials and the F1 are resolved, the Commission may exercise its discretion to recognize the Exchange.² If recognized, Staff will publish a notice indicating the approval of the Exchange recognition (Notice of Approval of Exchange Recognition) and the final recognition order.

¹ The F1 contains information about the Exchange that describes, among other things, the governance of the Exchange, the manner of operation of its trading system, the means of access to the market and the Exchange's listing criteria, fees and regulation.

² Some of the factors that would be considered by the Commission are described in Part 4 of 21-101CP.

(b) ATs

Pursuant to section 6.1 of NI 21-101, an ATS cannot carry on business in Ontario unless it registers as a dealer and is a member of a self-regulatory entity. Currently, the Investment Industry Regulatory Organization of Canada (IIROC) is the only applicable self-regulatory entity. An ATS must also file Form 21-101F2 *Initial Operation Report Alternative Trading System* (F2) at least 45 days before it begins to carry on business.³ The information in the F2 is similar to that provided in an Exchange's F1 and is also confidential for the same reasons.

An ATS is also expected to file a notice providing summary information regarding its operations, similar to that in an Exchange's Application, but modified accordingly to reflect the fact that an ATS does not perform regulation functions (Notice of Initial Operations). The information to be included in the Notice of Initial Operations is set out in the next section.

The ATS's Notice of Initial Operations is published and accompanied by a notice published by Staff for a 30-day comment period in the OSC Bulletin and on the OSC website. The review process by Staff is similar to the review process for an Exchange Application. Once all of the issues associated with the ATS's filing(s) are resolved, including any issues with the associated registration application, the registration as an investment dealer is issued and staff will publish a notice indicating that Staff's review is complete (Notice of Completion of Staff Review).

Where an existing registered investment dealer is proposing to operate an ATS, the same filing, publication and review processes apply.

IV. Information regarding initial operations

As noted above, when a marketplace plans to start operations and files the applicable documents, certain information is made publicly available to ensure transparency regarding the proposed operations of the marketplace and to give market participants an opportunity to provide feedback.

This information must be sufficiently detailed to allow marketplace participants to understand and assess the marketplace's proposed operations, given that the F1 or F2 is not published. As described in the previous section, in the case of an Exchange, this information would be contained in the Application and in the rules and policies that are published along with the Application. In the case of an ATS, the information would be contained in the Notice of Initial Operations. At a minimum, the Application or Notice of Initial Operations should include a description of:

- the structure of the marketplace, including how orders are entered, displayed (if applicable), executed, how they interact, and how they are cleared and settled;
- the marketplace's fees and fee model, if known;
- the services provided by the marketplace, including the hours of operation;
- the means of access to the market or facility and its services;
- the order types it offers;
- other information disseminated by the marketplace and the recipients of that information, such as indications of interest disseminated by a marketplace that operates without pre-trade transparency;
- the types of securities listed, quoted or traded on the marketplace, as applicable; and
- the types of marketplace participants.

If applicable, the materials published may include additional information, such as a description of the marketplace's policies and procedures to manage conflicts of interest, referral, outsourcing or custody arrangements, or any other information relevant to the entity's operations.

After the commencement of operations, a marketplace is required to maintain information regarding its operations on its website, in accordance with the disclosure requirements applicable to all marketplaces set out in section 10.1 *Disclosure by Marketplaces* of NI 21-101. Information regarding changes to a marketplace's operations, as reflected in changes to its F1 or F2, as applicable, may also be published for comment. The information to be filed for changes to a marketplace's F1 or F2 and the criteria and process for publication are set out in the Marketplace Protocols.

³ See subsection 3.1(2) of NI 21-101.

V. Systems and launch of operations

Before a marketplace commences operations or makes any material system change (including introducing a new market or trading facility), it must make publicly available the technology requirements to interface with or access the marketplace or trading facility, and must make testing facilities available. Specifically, NI 21-101 requires that a marketplace make all technology requirements publicly available at least three months before it begins operations or before it implements a material change to its technology requirements.⁴ NI 21-101 also requires a marketplace to make testing facilities available at least two months before beginning operations or before implementing a material change to its technology requirements.⁵

Marketplaces need to ensure that marketplace participants and service providers have a reasonable opportunity to make the necessary changes to their systems so that they can access the marketplace. This involves time to do technology work and to test the system. We believe that three months is a reasonable time to allow marketplace participants and third parties to do the necessary development work and testing. However, it has come to our attention that due to potential uncertainty in the timing and outcome of the regulatory review process, many marketplace participants and service providers will not begin the systems work and testing before the Notice of Approval of Exchange Recognition or Notice of Completion of Staff Review, as applicable, has been published. As a result, if a marketplace launches operations or implements material system changes shortly after publication of the applicable Notice, market participants and service providers may not have sufficient time to make necessary systems changes and to complete their system testing, notwithstanding the fact that the marketplace has made the technology requirements and testing facilities publicly available for the requisite time periods in compliance with NI 21-101.

When planning the launch of operations or the implementation of material system changes, we expect marketplaces to take into consideration the commercial reality that market participants and service providers may postpone systems work and testing until the Notice of Approval of Exchange Recognition or Notice of Completion of Staff Review, as applicable, has been published.

With respect to the launch of initial operations (or a new market or trading facility), marketplaces should consider postponing the launch for a period of at least three months from the date of the publication of the Notice of Approval of Exchange Recognition or the Notice of Completion of Staff Review (as the case may be), rather than from the date the marketplace makes the technology requirements publicly available. Experience has shown that a three-month period generally provides reasonable advance notice to ensure fair access to the marketplace, promote fair, efficient and orderly markets, and facilitate market participants' compliance with applicable rules, including the Order Protection Rule. However, in some cases a longer period may be required. We believe that allowing a reasonable delay of the launch fairly balances the needs of marketplace participants and service providers with the interests of the marketplace.

Once a marketplace has commenced operations, if it intends to make a material system change (other than introducing a new market or trading facility) that would require marketplace participants or service providers to do development work or testing, it is our expectation that the marketplace will conduct an assessment of the amount of time and effort required to do the necessary work. The marketplace should delay the implementation of the material change until marketplace participants and their service providers have had a reasonable amount of time to complete the necessary work and testing following the approval of the change. What constitutes a reasonable amount of time will depend on the materiality and complexity of the change and its impact on marketplace participants' ability to comply with applicable regulatory requirements. Normally, the impact on marketplace participants will be greater for markets that display details of orders (and are subject to the Order Protection Rule) than for marketplaces that do not provide pre-trade transparency of orders.

VI. Questions

Questions may be referred to any of:

Timothy Baikie
Ontario Securities Commission
(416) 593-8136

Jonathan Sylvestre
Ontario Securities Commission
(416) 593-2378

Tracey Stern
Ontario Securities Commission
(416) 593-8167

October 4, 2012

⁴ Subsection 12.3(1) of NI 21-101.

⁵ Subsection 12.3(2) of NI 21-101.