2000/10/05 — TSE Inc. — POSIT Call Market

Issue: October 5, 2001

Citation: 24 O.S.C.B. 5965

The Toronto Stock Exchange Inc. — Implementation of the POSIT Call Market Notice of Commission Approval

On September 4, 2001, the Commission approved amendments to the Rules and Policies of the Toronto Stock Exchange Inc. (the “Exchange”) to implement a call market as a facility of the Exchange (the “POSIT Call Market”) and to provide Participating Organizations and eligible institutional clients access to the POSIT Call Market. A copy and description of the amendments was published on June 8, 2001, at (2001) 24 OSCB 3559. Five comment letters were received. The Exchange's summary of the comment letters and the Exchange's response is set out below. The summarized comments are organized by issue with the Exchange's response following each summary.

1. — Web-Based Access V. Dealer/Vendor Conduits

Canadian access to POSIT will be through the Internet rather than through a more traditional routing by a dealer/vendor conduit to the Exchange. Two of the comment letters suggested that order routing should be through a more traditional application such as currently provided to access the auction market and that the Exchange could then build in features to assist in dealing with any credit risk. Another letter indicated that using Internet access reduces the value and efficiency of existing desktop trading technology infrastructures. Moreover, it was suggested that requiring later modifications to existing vendor technology would be technically difficult and costly.

The decision for POSIT to be accessed through the Internet was made so that users of the facility would be able to access it at a lower cost. The Exchange anticipates that the success of the facility will lead to vendors developing more traditional interfaces due to market demand. However, initially, users will be able to access POSIT without accompanying development costs at a vendor level.

2. — Credit Risk

All of the comment letters raised the issue of risk, whether credit risk or the inability of dealers to monitor or manage the order-flow of eligible institutional clients using POSIT. One letter requested that information regarding POSIT trades be provided after the last call at 2:30 p.m. rather than waiting until the market closed so that firms could remedy any “rogue” trading that might have occurred.

The Exchange believes that anonymity is a critical feature of POSIT. Anonymity will allow Participating Organizations ("POs") and institutions to execute trading strategies efficiently and with reduced market costs. As a result of anonymity, however, POs will not be able to review or manage Policy 2-501 client orders as they are entered into POSIT (comparable with the electronic value weighted average price ("eVWAP") facility) nor will they be able to obtain information with respect to those client's POSIT trades until the end of the day. Although this may heighten a PO's concerns about the credit and trading risks associated with an eligible institutional client, the Exchange considers these risks to be business risks that a PO should consider when initially authorizing a client to access POSIT by giving up their broker number.

POs offering clients access to POSIT will be required to negotiate and execute agreements to facilitate such access. These agreements may take the form of a separate agreement or as an addendum to a current system interconnect agreement required by Policy 2-502. Firms must assess the risk of allowing a particular client to access POSIT and then must manage any trade or credit risks using limits set out in the agreement with each client, together with post-trade reviews. A PO's decision will likely be based upon a client's sophistication and creditworthiness, thereby mitigating the firm's capital risk. Furthermore, firms may decide to require certain eligible clients to notify them throughout the day of trades executed in POSIT.

A query session is not currently available during the trading day since all of the trade information is not available until the close of trading.

The Exchange also believes that the risk of inappropriate trading may be mitigated by providing users with sufficient educational material regarding the Rules of the Exchange relating to the entering of orders. The Exchange will provide POs with training materials relating to POSIT but it will remain a PO's responsibility to ensure that their eligible institutional clients receive adequate training. POs will be provided with a demo of the POSIT facility and also will have an opportunity to participate in a live Beta test which will allow participants to obtain a higher level of familiarity with the product prior to implementation.

3. — Eligible Clients — Access

One letter requested additional details regarding the process that institutional clients will use to access POSIT through a PO. Another requested additional information as to the process by which the Exchange will establish the authority of a client to trade under a PO's trade number. Clarification was also requested with respect to foreign market participants and how they will access POSIT.

To access POSIT, all eligible institutional clients will be required to sign an agreement pursuant to Policy 2-502 with a PO authorizing access to POSIT and designating that PO as the PO responsible for that client's orders. POs will be required to indicate to the Exchange the clients with whom such agreements have been executed. Clients will have to designate a responsible PO for each POSIT order prior to that order being accepted by the facility. At the end of the trading day, POs can query the trade report to obtain information regarding its eligible clients' trading in POSIT for that day.

A process to ensure that a client is properly authorized by a PO to enter orders into POSIT using that POs trading number, together with proper documentation, is in development and will be communicated to the industry prior to the implementation of POSIT.

POSIT will be available for access by users outside of Canada in the same way that the continuous market is now available. Policy 2-501 clients will be able to access POSIT through an application on an approved system interconnect and the orders will be routed through a Canadian PO while maintaining anonymity.

4. — Liability for Policy 2-501 Clients' Trades

One comment letter indicated that the Exchange should assume liability for Policy 2-501 client trades entered directly into POSIT since POSIT falls within the definition of a "marketplace" under the proposed Alternative Trading System Proposal ("ATS Proposal") and Universal Market Integrity Rules ("UMIR").

Unlike an ATS offering access to any subscriber, to enter orders into POSIT, a user must be a PO of the Exchange or an eligible client of a PO that has been authorized to enter orders directly into POSIT. As a result, the PO is liable for any orders entered by a client that gives up the PO's number for clearing and settlement purposes.

5. — Reports

In the Request for Comments, the Exchange indicated that POs will be responsible for building access to the STAMP trade query in order to access end of day trade information for POSIT. One commenter indicated that the Exchange should develop software to allow POs to access the end-of-day trade information. Another was concerned about the timelines required for this development.

The Exchange is developing the actual trade query where the information regarding POSIT trades will be stored. However, POs or vendors will be responsible for developing the ability to obtain the information that is stored in the query. This is comparable to the ability POs currently have to query order-book information or to accept that queried information.

The Exchange anticipates Beta testing to begin in POSIT in December 2001 and implementation in the first quarter of 2002. POs and vendors will be provided with 90-days notice of the specifications for this query as is required for all system changes at the vendor level.

6. — Fee Structure

A number of comment letters requested information regarding the fee that will be charged for trades matched in POSIT.

Trades in POSIT will be charged the same trading fees by the Exchange as are charged for trades executed in the auction market. However, since both sides of a match in POSIT will be considered active, both sides will be charged a trading fee. The Exchange is sensitive to the issue of all fees charged and is committed to remaining competitive in this regard. The Exchange will not be regulating the commissions that POs negotiate with their clients with respect to POSIT.

7. — Order Entry by TSE Staff

One comment letter indicated concern with the ability of Exchange Trading Services staff to access orders in the POSIT facility to assist users if they are having problems accessing the system.

The extent to which the Exchange could change a client's POSIT order would be limited to the specific request of the client or dealer and only with respect to a systems problem that the client or dealer was experiencing. The Exchange would execute such changes in the nature of an order entry clerk function. This approach is the same as currently exists for the continuous market.

8. — Harmonization With Existing Rules of the Exchange and the Universal Market Integrity Rules ("UMIR")

In the proposed Rule and Policy package relating to POSIT, the Exchange has requested exemptions from Policy 2-502 relating to access by eligible institutional clients; Policy 6-501 dealing with Normal Course Issuer Bids; Rule 4-301 relating to short sales; and Rule 4-501 relating to client priority. In response to these proposed exemptions, one letter requested that the Exchange provide information on how the trading rules relating to POSIT would fit into the UMIR. Another letter indicated that caution was needed in considering these exemptions since each exemption granted for an Exchange trading system will set a precedent for dealers and Alternative Trading Systems ("ATSs").

The exemptions from the short sale and client priority rules would be necessary under UMIR. The other exemptions would be market specific and therefore would not be required from UMIR. No other exemptions from UMIR are anticipated; however UMIR has not to date been finalized nor approved and therefore, should any changes occur, these would have to be taken into account with respect to any trading system operated by an exchange.

The Exchange agrees that caution is needed in considering these exemptions and TSE Regulatory Services ("TSE RS") considered the impact upon the market carefully prior to proposing such exemptions. The Exchange and TSE RS believe that trades executed in POSIT would not involve the types of abuses that these rules were designed to address, due to the inherent features of POSIT — the random call times, matching algorithm and the pricing mechanism. Instead, without these exemptions, trades in POSIT may result in violations over which the user has no control but which are a function of the features of the facility. As a result, in order to facilitate the use of POSIT for as many users as possible, these exemptions are necessary. Should a user attempt to manipulate either the POSIT price or the auction market as a result of these exemptions, the Exchange is confident that the monitoring tools developed for Market Surveillance to monitor POSIT in conjunction with the continuous market will detect such trading activity, those trades will be reviewed and the appropriate action taken.

9. — Market Manipulation

A concern regarding the potential for market manipulation was raised in two comment letters. The primary concern was that the five-minute random call time would not sufficiently reduce the possibility of manipulation, particularly for a less liquid security. In particular, one letter commented that an exemption from the short sale rule in conjunction with POSIT trades being eligible to set the last sale price might result in a client executing a short sale in POSIT and the POSIT trade setting a last sale that moves the market downward, thereby allowing the client to execute a short sale in the continuous market at a price at which the trade otherwise could not be executed.

The Exchange recognizes that attempts may be made to influence the POSIT price or to use POSIT to downtick a stock in order to facilitate a short sale in the auction market. The Exchange believes, however, that the enhanced Market Surveillance tools which will compare activity in POSIT with activity in the continuous market, and which will generate a number of alerts, will detect attempts at manipulation which can be dealt with in an appropriate manner. Market Surveillance staff will also have access to the POSIT trade report and to a list of orders after each call, enabling staff to compare order information against the trades in POSIT and in the continuous market.

In the U.S., the Securities and Exchange Commission ("SEC") required POSIT to develop a monitoring system ("POSITWatch") to detect and guard against market manipulation. The Exchange analyzed POSITWatch and decided that staff could develop a superior system for use in Canada. The Exchange's enhanced monitoring tools are a result of this effort. In addition, in the U.S. any evidence of potential manipulation detected by POSITWatch is simply reported by POSIT to NASD for investigation. Should Market Surveillance staff be alerted to a potentially manipulative trade, they will exercise discretion in assessing the situation and cancel the questionable trade where appropriate. Such intervention will lessen the impact on the market and provide a greater deterrent to the marketplace overall.

With respect to the proposed exemption to the short sale rule, the SEC granted a short sale exemption to POSIT in 1994 with two conditions: i) that the persons relying on the exemption shall not be represented in the primary market or otherwise influence the primary market bid or offer at the time of the transaction; and ii) transactions effected on POSIT shall not be made for the purpose of creating actual, or apparent, active trading, in or depressing or otherwise manipulating the price, of any security. The Exchange is of the opinion that the first of the conditions above restricting those persons relying upon the short sale exemption from being in the continuous market is unnecessary.

Should a short sale occur that is the only POSIT trade in that security and which would effectively downtick the price of the security in the continuous market, Market Surveillance staff would, in the normal course of their review, address the transaction. If Market Surveillance staff were concerned about potential manipulation, the POSIT trade would be cancelled. If, however, there were a number of trades in POSIT at the same price in that security, the presence of a short sale in POSIT should not raise concerns regarding manipulation. The randomness of the calls should also act as a prohibiting factor should someone attempt manipulation.

10. — Exemption from Client Priority Rules

Two letters expressed concern with the proposed exemption from the client priority rules and suggested that there is a conflict when the TSE is exempted from its own rules whereas dealers and vendors are required to modify their systems to comply with the same rules.

The exemption that the Exchange has proposed is merely an exemption from the client priority rules for those orders entered into POSIT by an eligible institutional client. As a result of the anonymity feature of POSIT, a designated PO will not be aware of client orders being entered into POSIT by an eligible client. Once in the system, the allocation algorithm treats all orders equally as it maximizes share matches within any constraints imposed by participants. Consequently, a PO could potentially receive a better fill than a client but have no idea that the client order had been entered into POSIT. To avoid such inadvertent violations of Rule 4-501 the Exchange proposes that the rule not apply to eligible institutional client orders entered into POSIT without review by or the knowledge of a PO. A comparable exemption has been granted for the eVWAP facility that also provides eligible institutional clients anonymous access.

The Exchange does not believe that this exemption is contrary to a firm's fiduciary obligation to provide best execution for its clients since it is the client's choice to send its orders directly to POSIT, the orders are anonymous, and the allocation algorithm treats all orders equally.

In the U.S., POSIT trades are executed by ITG Inc., a registered broker dealer which acts as agent for both the buyer and seller. As a result, all orders received are client orders that are treated equally by the allocation algorithm in its attempt to maximize shares matched within the constraints imposed. Matches are then reported to the New York Stock Exchange (“NYSE”). If one of the clients is a broker, that broker has a responsibility to re-allocate after the POSIT match to comply with the client priority rule. Pursuant to Exchange Rule 4-501, orders entered directly into a trading system satisfy a firm's client priority obligations and therefore such orders in POSIT would not require reallocation.

11. — Indemnification

One letter requested clarification with respect to the indemnification provision proposed to be added to the system interconnect agreements required pursuant to Policy 2-502. Another letter commented that if ATSs are responsible for all transactions in their system, the Exchange should be responsible for trades in POSIT.

The indemnification that the Exchange has proposed to be added to the Policy 2-502 system interconnect agreements will indemnify third party vendors that have provided software, hardware or services to the Exchange in support of trading systems. In other words, the indemnification is not for the Exchange but in the case of POSIT, it provides indemnity from end users of POSIT for POSIT-JV (a joint venture of ITG Inc. (ITG U.S.) and Barra, Inc.) which is merely licensing the software to the Exchange and therefore is not connected to the operation of the trading system. This indemnification is comparable to those provided in many software licensing contracts for third party vendors who are not actually operating the systems in question.

The TSE has no jurisdiction over clients, only POs. It is within the POs' discretion whether to grant access to a client and correspondingly, it is the POs' obligation to ensure that clients know about and comply with Exchange rules.

With respect to ATSs, they will have the choice as to how they decide to be set up, i.e. they may do so as a broker dealer or as an exchange. If an ATS is set up as a broker dealer using Exchange facilities to execute orders, it is the ATS that would be responsible for settlement of trades, as would any other broker.

12. — POSIT Price Setting Last Sale Price

Two comment letters suggested that POSIT trades should not be eligible to set the last sale price in the continuous market. One letter indicated that the market displacement rules that apply to crosses should also apply to matches executed in POSIT. This would not allow a POSIT trade to be reported to the market if the POSIT price was no longer within the bid and ask at the time the trade is reported.

Another letter stated that the POSIT price should be used in the Exchange's eVWAP calculation but should not be used to set the last sale price.

The Exchange's position is that the POSIT price, at the mid-point of the bid and ask at the time of the call, is representative of the market and therefore should be eligible to set the last sale price and be used in the calculation of the VWAP price.

The timeframe between the execution of the match and reporting is anticipated to be no more than 3 minutes. If the POSIT price is outside the bid and ask at the time it is reported, that trade will not be eligible to set the last sale price. As a result, only in extremely liquid stocks is it likely that the POSIT price for a trade will be outside the bid and ask in the continuous market when it is reported. For those stocks it is also unlikely that the POSIT trade will actually set the last sale price.

In the US, POSIT executions are printed as third market executions to the Composite Tape System (“CTS”). The POSIT execution price cannot, therefore, represent the last sale on the NYSE since the NYSE only uses executions done on NYSE to determine its last sale price. Therefore, although a POSIT trade can set a CTS closing price it does not set a primary exchange closing price. For NASDAQ securities, NASDAQ uses the last trade on the CTS to determine the closing price, which could be a POSIT trade if no executions occur between the last POSIT match of the day and the close of the market.

Unlike crosses being done internally by a PO, POSIT will be open to all market participants at set times. Moreover, POSIT trades will have a special marker indicating that they were executed in POSIT so market participants will know instantly why such a trade may appear out of sequence when reported if the market has moved in the interim. As an additional protection, should the POSIT trade price appear to be unfair based upon the price movement in the continuous market, the Exchange's Market Surveillance staff can cancel the POSIT trades in that stock.

13. — Minimum Order Size

One letter indicated that the minimum proposed order size in POSIT (one board lot size for that security) is too small due to the costs involved in tracking and settling POSIT trades for eligible institutional clients. A minimum order size of 5,000 shares was recommended.

The Exchange chose the minimum order size as the board lot size for a security in order to provide access to a wide variety of users. The board lot order size is consistent with the continuous market and therefore it was thought that it would be appropriate for POSIT since the cost of trading fees as well as clearing and settlement should be consistent. The Exchange recognises that there will be an initial cost to developing the ability to query the Trade Report information. However, once that initial outlay is made the costs of clearing and settlement should be the same as regular trades in the continuous market. This is more of a business issue than a regulatory one. If the order size is too small, usage will be limited causing the issue to be re-evaluated by the Exchange.

14. — Price Increments

One commenter suggested that the POSIT price be calculated to two decimal points rather than three as three will produce prices that have less than a one cent increment.

POSIT in the U.S. also calculates the POSIT price to three decimal points. The POSIT price is calculated as the mid-point of the bid and ask in the continuous market at the time of the call. Consequently, it is necessary to calculate the price to, at a minimum, three decimal points to accurately reflect the mid-point price. If the price was to be consistently rounded up or down it would not accurately reflect the mid-point price, particularly if the spread for a stock was tight. Should, however, the marketplace move to a set minimum price increment the Exchange would reconsider the POSIT price increment.

15. — Stock Participation in Match

One commenter suggested that certain conditions should result in precluding a stock from participating in a match. For instance, if the spread is too wide or if the stock price is different from the "limit" price placed on an order at the time the order is entered.

In POSIT, if there is no bid or ask for a stock that stock will not participate in a match. However, if a spread is too wide, rather than the stock being restricted from participating in the match Market Surveillance staff will, in the normal course of monitoring, review the pricing to determine whether or not it is fair. If it is not, the trades will be cancelled. POSIT gives a client the ability to set a limit price on an order. Should a client choose to impose such a constraint and the mid-market price has moved above that price, that particular order will not participate in the match although the stock will participate. This ensures that the match occurs for all participants who want to participate at the mid-point price for that stock.

16. — Exemptions from Standards

One letter indicated that previous requests by other institutions for exemptions from current standards and practices had been denied and asked why it was that the TSE, or the OSC/CSA, had finally agreed to allow exemptions for POSIT.

The Exchange's rules allow POs to operate alternative trading systems that are integrated with the Exchange and limited to orders of 1200 shares or more (the threshold for the order exposure rule); two POs of the Exchange do so. The Exchange has in the past accommodated requests for exemptions from various rules to accommodate POs offering ATS services. The Exchange supported Instinet's application for removal of certain restrictions on its operation arising from its initial application for membership in the 1980s.

The Exchange lowered the order size threshold for member ATSs from 10,000 to 1200 shares in response to requests from ATS operators. In another example, an Exchange by-law amendment was adopted to allow POs to enter jitney crosses, on the bid or offer, if the trade was one leg of a bona fide mid-market trade. Where specific requests for rule amendments to accommodate their systems have been made, the Exchange has tried to accommodate the member. Finally, the Exchange anticipates that the Canadian Securities Administrators will shortly issue rules for ATSs to operate outside of the Exchange framework, allowing even greater ability to offer competitive trading systems.