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ALTERNATIVE TRADING SYSTEM PROPOSAL

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**NOTICE OF PROPOSED
NATIONAL INSTRUMENTS, COMPANION POLICIES
AND ONTARIO SECURITIES COMMISSION RULE
UNDER THE SECURITIES ACT**

**NOTICE OF PROPOSED
NATIONAL INSTRUMENT 21-101
MARKETPLACE OPERATION,
COMPANION POLICY 21-101CP AND
FORMS 21-101F1, 21-101F2, 21-101F3 AND 21-101F4**

AND

**NOTICE OF PROPOSED
NATIONAL INSTRUMENT 23-101
TRADING RULES AND COMPANION POLICY 23-101CP**

AND

**NOTICE OF PROPOSED ONTARIO SECURITIES
COMMISSION RULE 23-501 DESIGNATION AS MARKET
PARTICIPANT**

AND

**DISCUSSION PAPER ENTITLED "CONSOLIDATION
PLAN FOR A
CONSOLIDATED CANADIAN MARKET"**

Introduction

The Commission, together with the other members of the Canadian Securities Administrators ("CSA") staff, are publishing for comment proposed National Instrument 21-101 Marketplace Operation (the "Instrument"), Companion Policy 21-101CP (the "Policy"), Forms 21-101F1, 21-101F2, 21-101F3 and 21-101F4 (the "Forms"), proposed National Instrument 23-101 Trading Rules ("Trading Rules"), Companion Policy 23-101CP ("Trading Rules Policy") and a Discussion paper on a Plan for a Consolidated Canadian Market ("The Consolidation Plan"). The CSA staff are also publishing a background paper, attached hereto as Appendix "A", entitled "Regulation of Alternative Trading Systems in Canada" presenting the history and debate on the issues concerning the operation of alternative trading systems ("ATSS") in Canada. In addition, Ontario Securities Commission Rule 23-501 Designation as Market Participant ("Rule 23-501") is also being published for comment. Rule 23-501 designates a recognized quotation and trade reporting system to be a market participant for purposes of the definition of "market participant" in subsection 1(1) of the *Securities Act* (Ontario). As a result, all provisions in the *Securities Act* (Ontario) that apply to market participants will also apply to recognized quotation and trade reporting systems.

The documents currently being published for comment have been prepared by a working committee of CSA staff. The documents have been formally approved by some, but not all, commissions. In light of the desire to publish the ATS proposal, the documents are being published now for public comment. It is expected that formal approval by all commissions will be forthcoming.

The proposed National Instruments are initiatives of the CSA, and are proposed to be adopted as rules in each of British

Columbia, Alberta, Manitoba, Nova Scotia and Ontario, as a Commission regulation in Saskatchewan and as a policy in each of the other jurisdictions represented by the CSA. The proposed Forms are initiatives of the CSA and are proposed to be adopted as rules in Ontario. The proposed Companion Policies are initiatives of the CSA and are proposed to be adopted as policies in each of the jurisdictions represented by the CSA.

**A. THE INSTRUMENT, POLICY AND FORMS-
SUBSTANCE AND PURPOSE**

Scope of the Instrument, Policy and Forms

The Instrument and Policy regulate all marketplaces operating within the jurisdictions of the CSA. Marketplaces include recognized stock exchanges, recognized quotation and trade reporting systems as well as ATSS. A marketplace participant is defined to mean a member of an exchange, a user of a quotation and trade reporting system or a subscriber of an ATS. The Instrument and Policy provide guidelines for establishing which types of marketplaces are considered to be exchanges and must be recognized as exchanges and which types of marketplaces may be considered as ATSS.

The Instrument sets forth a number of requirements for exchanges and quotation and trade reporting systems, such as reporting and record keeping. These requirements exist currently in some jurisdictions. The Instrument further specifies several new requirements including access and systems capacity requirements that reflect the increased importance of technology for these markets, and transparency and market integration requirements. The Instrument specifies which of these requirements will also apply to ATSS. The Forms are required to be filed by marketplaces when commencing to carry on business and must be filed by an ATS to report on certain activities and when ceasing to carry on business.

Purpose of the Instrument and Policy

The Instrument is intended to provide an appropriate regulatory framework within which traditional markets, such as exchanges, and new markets, such as ATSS, can operate. The Policy sets out guidelines regarding the application of the Instrument.

Discussion of Instrument and Policy

During the last ten years there have been numerous discussions regarding whether electronic trading systems should be permitted to operate in Canada and what their effect would be on traditionally recognized and regulated markets¹.

¹ See Background Paper entitled "Regulation of Alternative Trading Systems in Canada" attached to this notice which presents a brief history of the events regarding ATSS and summarizes the key issues. See also: *Request for Comments and Notice of Forum to Discuss "NETS" and Market Fragmentation* (1997), 20 OSCB 2565 (the Ontario Securities Commission published the request for comments and notice of forum on May 16, 1997) and *Summary of comments received in response to the Request for*

The debate centered on the causes and effects of fragmentation as well as on how to regulate these new types of entities. At the current time, exchanges, dealers and investors acknowledge that various types of electronic trading systems have developed in response to investor demand for different services and fee structures than are now provided by exchanges.

The Instrument and Policy focus on how to regulate ATSs and how to minimize any negative effects of fragmentation through consolidation of information and order integration. Discussion of the relevant parts of the Instrument and Policy will be divided into the following topics: (1) The concepts of marketplace and ATS; (2) Recognition of exchanges and quotation and trade reporting systems; (3) Regulatory choices for ATSs; (4) Regulatory requirements for ATSs that choose not to be an exchange or member of an exchange; (5) Information consolidation and market integration requirements for marketplaces; (6) Recordkeeping requirements and systems' capacity and integrity requirements (7) Carrying on business as an ATS within a jurisdiction. A section by section summary is set out in Appendix "B".

1. The Concepts of Marketplace and Alternative Trading System

Part 1 of the Instrument sets out a definition of "marketplace". A marketplace is defined as an exchange, a quotation and trade reporting system and any other person or company that (a) constitutes, maintains or provides a market or facilities for bringing together purchasers and sellers of securities, (b) brings together the orders for securities of multiple buyers and sellers, and (c) uses established, non-discretionary methods under which the orders interact with each other and the buyers and sellers entering the orders agree to the terms of a trade. Part 2 of the Policy provides further explanation of this concept.

In developing the appropriate regulatory framework for ATSs within the Canadian capital markets, the CSA have determined what is an ATS, how it differs from a traditional exchange, and which characteristics should require an ATS to be regulated as a recognized exchange. Historically, exchanges have brought together buyers' and sellers' orders for securities. As world markets have evolved, so have exchanges. They do not all perform the same functions or even have the same types of governance structures as they have had in the past. ATSs also provide a marketplace for buyers' and sellers' orders.

As set out above, the Instrument provides a broad definition of "marketplace" that includes both exchanges and ATSs. The definition of ATS then identifies certain characteristics that the CSA believe require an entity to be regulated as an exchange. The characteristics are: providing a listing function, carrying out market regulation, disciplining subscribers or providing a guarantee of liquidity through intermediaries such as professional market makers. Part 3 of the Policy states that

if a marketplace lists securities, provides guaranteed liquidity, disciplines marketplace participants or carries out market regulation, then it would have to apply for recognition as an exchange. Subsection 6.4 (1) of the Instrument requires an ATS to notify the appropriate member of the CSA before it begins to do any of these functions. The ATS would then be required to apply for recognition as an exchange.

Traditional dealer activity is excluded from the concept of marketplace (and is therefore neither a characteristic of an exchange or an ATS) because such activity is not characterized as bringing together orders of multiple buyers and sellers through non-discretionary methods of order execution. Using internal systems to trade and manage orders does not cause a dealer to be an ATS or marketplace, if the dealer exercises discretion or judgement over customer orders. An example of systems that do not use non-discretionary methods are traditional block trading desks which retain discretion and frequently commit capital to satisfy customer needs.

Subsection 2.1 (5) of the Policy identifies additional circumstances that are not considered to qualify a system as a marketplace: an issuer selling its own securities (one seller and multiple buyers), order routing systems and bulletin boards.

Subsection 6.5(1) of the Instrument describes another factor that could cause the members of the CSA to determine that a marketplace should be recognized as an exchange. If the volume of trading activity in a type of security reaches 40 percent of the average daily dollar value of the trading volume in that type of security traded in Canada, then by virtue of the level of trading on the system, and the importance of ensuring that access is provided to all investors, the CSA will consider whether the system should be considered to be an exchange and therefore regulated as an exchange. The CSA are of the view that if a trading system reaches the threshold, it is in a position to be the dominant market in some important segment of the securities market. This threshold is triggered based on any three of the ATSs previous four calendar quarters. The ATS is required to notify the appropriate member of the CSA when it reaches the threshold.

Question 1:

Is 40 percent 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 percent or 20 percent)?

There is another volume threshold set out in paragraph 6.5(1)(b) of the Instrument. If the volume of trading activity reaches 50 percent of the average daily dollar value of the trading volume in any security and 5 percent of the average daily dollar value of the trading volume in any type of security traded in Canada, then, the CSA will consider whether the system should be considered to be an exchange and therefore regulated as an exchange. The CSA are of the view that if a trading system reaches this threshold, it is in a position to be a dominant market by achieving substantial activity in a

Comments concerning Non-SRO Electronic Trading Systems and Market Fragmentation (1998), 21 OSCB 1443.

specific issue and the CSA will consider whether the system should be regulated as an exchange. As set out above, the ATS is required to notify the appropriate member of the CSA when it reaches the threshold for any three of the previous four calendar quarters. The CSA are considering whether this requirement is appropriate and is specifically requesting comment on whether to retain the requirement.

Question 2 :

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

The CSA are requiring an ATS to notify the appropriate member of the CSA when the volume thresholds set out above are reached. The volume thresholds are determined based on trading both inside and outside Canada. The CSA are requesting comment on the feasibility of an ATS to calculate the threshold specifically with respect to trading on marketplaces outside Canada.

Question 3 :

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

2. Recognition of Exchanges and Quotation and Trade Reporting Systems

Part 5 of the Policy discusses factors that a jurisdiction would review as part of the recognition process. Recognized exchanges today have regulatory responsibilities and requirements imposed upon them by the Canadian securities regulatory authorities. For the most part, the requirements set out in Part 5 are the standards that the Canadian securities regulatory authorities, as well as securities regulators outside of Canada, have applied and are currently applying to recognized markets. These standards, however, are not set out in securities legislation. In the course of discussions regarding ATSs, it was suggested that, if ATSs are given the ability to be regulated as exchanges, then the standards for being recognized as an exchange and requirements applicable to exchanges should be made clear. Part 5 of the Instrument contains requirements applicable to recognized exchanges and recognized quotation and trade reporting systems. Parts 7-11 of the Instrument provide some new requirements which will be applicable to all marketplaces. See discussion below.

3. Regulatory Choices for ATSs

The definition of ATS provides that an ATS is not a recognized quotation and trading system or exchange. Therefore, if it chooses to be recognized as an exchange, it is not an ATS. Section 2.1 of the Instrument provides that an ATS is excluded from the Instrument if it is a member of a recognized exchange. Section 6.1 of the Instrument establishes the regulatory model for ATSs that are not recognized as an exchange or a quotation and trade reporting system and are not members of a recognized exchange. Thus, ATSs can choose to be recognized as an exchange, become a member of an exchange and be regulated in the same manner as any other exchange member, or become registered as a dealer

which is a member of a "self-regulatory entity" (a term defined in section 1 of the Instrument). At this time, the Investment Dealers Association of Canada (the "IDA") is the only body that would come within the definition of a self-regulatory entity. If the ATS chooses to be a member of the IDA it will be subject to the additional requirements applicable to ATSs (set out in Part 6 of the Instrument) and marketplaces (set out in Parts 7-11 of the Instrument).

Unless an ATS is recognized as an exchange, an ATS will not be subject to the requirements set out in Parts 3, 4 and 5 of the Instrument that are only applicable to recognized exchanges or recognized quotation and trade reporting systems. This is because the definition of "ATS" excludes recognized exchanges and recognized quotation and trade reporting systems.

4. Regulatory requirements for ATSs that choose not to be an exchange or member of an exchange

ATSs will be limited to trading "ATS securities". Part 1 of the Instrument defines an "ATS security" as securities of reporting issuers, a derivative of such securities, government debt, or securities listed or quoted on markets outside of Canada that are set out in an Appendix to the Instrument. When all jurisdictions have rulemaking or regulation making authority for commodity futures products, the CSA expect to extend the definition of ATS security to include commodity futures contracts traded on an exchange. The CSA are requesting comment on whether securities of a reporting issuer traded on an ATS should be limited to those securities that are listed on a recognized exchange. This would prohibit establishing an ATS for trading securities of reporting issuers that are quoted or reported on CDN.

Question 4:

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

The CSA are specifically requesting comment on which foreign markets should be included in the Appendix to the Instrument.

Question 5:

Which foreign markets should be included in the Appendix to the Instrument?

Part 6 of the Instrument sets out requirements that are applicable to ATSs that are not recognized as exchanges or are not members of an exchange. Section 6.1 states that the ATS must be registered as a dealer and be a member of a self-regulatory entity which does member regulation and is not an exchange. Sections 6.2 and 6.3 set out the initial reporting requirements, ongoing reporting requirements and the reporting requirements upon ceasing operation of an ATS. In addition, subsection 6.4(1) requires an ATS to give notice to the appropriate member of the CSA if it begins to do any of the functions that the CSA generally consider to be functions of an exchange.

Section 6.6 prohibits a person or company that operates an ATS from principal trading. The CSA were concerned that without such prohibition, dealers with large volumes of trading might consider withdrawing from exchanges and operating as ATSs. The CSA have decided to impose this restriction after becoming aware that most systems operating in the U.S. do so only on an agency basis. The CSA believe that this requirement will help maintain a level playing field. The CSA specifically request comment on whether there should be a *de minimis* exemption for principal trading in order to encourage dealers to invest in ATSs. A restriction based upon the total volume of trading (e.g. 10 percent of the ATS' trading volume could be from principal trading of a participant dealer) or based upon the percentage of holdings in an ATS (e.g. 10 percent ownership in an ATS) could be used.

Question 6:

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

5. Information consolidation and market integration requirements for marketplaces

In order to minimize any negative impact of having different marketplaces trade the same security, Part 7 of the Instrument requires information transparency and Part 8 of the Instrument requires market integration. The purpose of the information transparency and market integration requirements is to preserve the benefits of a centralized market by taking advantage of technology. The goal is to provide the mechanisms for any investor to access the best priced order in Canada. This is described in more detail in the Consolidation Plan

Part 7 of the Instrument deals with information transparency requirements. Both pre-trade information (section 7.1) and post-trade information (section 7.2) must be provided to the "data consolidator" in real-time. As described in the Consolidation Plan, the data consolidator will be the person or company chosen by the CSA to consolidate pre-trade and post-trade information. Part C of this notice provides further details on how the CSA propose to choose the data consolidator and how it plans on implementing the establishment of information consolidation.

Section 7.1 requires any marketplace (recognized exchanges, recognized quotation and trade reporting systems, and ATSs) that displays orders to provide to the data consolidator information on such orders in the form of total disclosed volume at each of the five best price levels for each security traded. Disclosed volume refers to the portion of an order that is displayed in the marketplace. Volumes that are not disclosed or that are "reserve" or hidden volumes are not required to be displayed. Section 7.2 requires the marketplace to provide information on all trades executed (whether or not the orders had been disclosed) including the volume, symbol, price, and time of the trade.

An "order" is defined in Part 1 of the Instrument as a firm indication of a willingness to buy or sell a security. Part 6 of

the Policy provides additional guidance regarding what is an "order" for purposes of the Instrument. In order for parties to determine if the displayed price is in fact the best price, after taking into consideration the transaction fees, Part 9 of the Instrument requires that if the marketplace's transaction fee is greater than \$0.005 per security purchased or sold, then the transaction fee must be included in the price displayed by the data consolidator.

Part 8 of the Instrument requires a marketplace to provide access for execution to any orders the marketplace has displayed through the data consolidator. The purpose of requiring market integration is so that any buyer or seller in a marketplace will have the right and the ability to access the best price offered or bid in any other marketplace, regardless of whether the buyer or seller is a marketplace participant in that system or not. The order will be executed in accordance with the execution rules (algorithms) of the marketplace receiving the order (*i.e.*, the marketplace where the passive order is located). See subsection 8.1(2) of the Instrument and section 11.1 of the Policy for further explanation. Subsection 8.1(3) of the Instrument requires the marketplace to provide "equivalent access" so that access is meaningful and section 11.2 of the Policy provides guidance as to the meaning of that term. In particular, subsection 11.2(2) states that using different technology to execute orders, responding more slowly to orders of non-participants, or charging fees that have the effect of creating a barrier to access would not be permitted. However, commercially justified conditions for execution (such as all or none, delayed delivery, "cash") are, of course, permitted.

6. Recordkeeping requirements and systems' capacity and integrity requirements

The recordkeeping requirements allow the Canadian securities regulatory authorities to check compliance with the Instrument. Requirements for appropriate systems' capacity and integrity requirements are necessary to reduce risks of disruptions of the Canadian market due to failure of a significant marketplace to have proper capacity, recovery and back-up capabilities. The purpose of these requirements is to promote and maintain the integrity of and confidence in the markets.

Part 10 of the Instrument imposes additional recordkeeping requirements for marketplaces regarding the identification of participants and daily trading summaries including time sequenced records of order information.

Part 11 of the Instrument specifies requirements regarding capacity estimates, stress tests of critical systems, review procedures for system development, contingency planning and an annual independent review. These requirements will be applicable to recognized exchanges, recognized quotation and trade reporting systems, and ATSs whose size reaches 20 percent of the daily dollar trading volume in any type of security. Part 13 of the Policy provides additional guidance on how to implement these requirements. While these requirements have not traditionally been imposed on marketplaces, the CSA believe that increased reliance on technology makes these requirements prudent business practice and a necessity to ensure the integrity of the

Canadian capital market. Consideration may be given at a later date whether such systems' integrity requirements should be extended to dealers or service providers.

7. Carrying on business as an ATS within a jurisdiction

The CSA believe that it is necessary to consider when an ATS would be carrying on business in a jurisdiction which would require compliance with this Instrument and the Trading Rules. The CSA are seeking comment on whether and under what circumstances the mere placement of terminals or providing network access in a jurisdiction by an ATS would cause the ATS to be found to be carrying on business within the jurisdiction as opposed to providing "remote access." The Canadian securities regulatory authorities are considering this issue both in the context of remote access to trading systems within Canada and remote access to trading systems outside of Canada.

(a) Canadian ATSs carrying on business in a jurisdiction

Staff of the members of the CSA ("CSA Staff") are of the view that the extent and nature of the contact with investors should determine whether an ATS is carrying on business in a jurisdiction. This would mean that if an ATS provided investors with direct access to its system, marketed its services to investors or provided training to investors, then the ATS would be carrying on business in any jurisdiction where such investors were located. However, if the ATSs' only contact was with dealers registered in the jurisdiction (hereafter referred to as "remote access"), then it would only be subject to the regulatory requirements in its home jurisdiction (hereafter referred to as the "Home Jurisdiction Approach."). In respect of a Canadian ATS carrying on business in another Canadian jurisdiction, the home jurisdiction of the ATS would be the jurisdiction where the ATS' head office is located, as set out on Form 21-101F2.

If the investor's access to the ATS is only through a locally registered dealer, then the investor could have sufficient protection because it has the benefits of local law and registration requirements, particularly if the dealer is a member of a self-regulatory organization recognized in the local jurisdiction. In addition, if the ATS is regulated in its home jurisdiction, the investor will also indirectly (and maybe even directly) receive the benefits of any regulatory requirements imposed in the home jurisdiction.

CSA Staff believe the Home Jurisdiction Approach works particularly well if the home jurisdiction is another Canadian jurisdiction and all of the CSA jurisdictions adopt the Instrument and Trading Rules. Under these circumstances, the regulatory requirements are the same but the reporting and oversight will be streamlined.

Question 7:

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

Question 8:

What limitations should be placed on the ATS' activities in a dealers' jurisdiction if

the CSA adopts the Home Jurisdiction Approach?

Question 9:

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

(b) Foreign ATSs carrying on business in a jurisdiction

In recent years, several trading systems outside of Canada have proposed permitting access to their trading facilities. In limited circumstances, some trading systems have been permitted to provide terminals in Canada. For example, in Ontario, in September 1995, Instinet U.S. was granted registration as an international dealer, which permitted it to provide terminals to Ontario Designated Institutions (a term defined in Regulation 1015 to the *Securities Act* (Ontario)) to trade foreign securities which are not listed on a Canadian stock exchange directly on the Instinet network. This arrangement was permitted until the issues regarding ATSs were dealt with on a broad policy basis.

The CSA have been examining different alternatives for addressing these concerns. At this time, the Canadian securities regulatory authorities are considering whether an approach similar to that set out above is appropriate for trading systems that are located and regulated outside of Canada. Specifically this would mean that if a foreign ATS provided direct access to investors, marketed its services to investors or provided training to investors in a jurisdiction, then the ATS would be carrying on business in any jurisdiction where such investors resided. However, if the ATSs' only contact was with dealers registered in the jurisdiction, then it would only be subject to the regulatory requirements in the foreign jurisdiction which is its home jurisdiction. This would be similar to when a Canadian dealer contacts a foreign dealer to execute a customer's order in a foreign market. Currently, Canadian regulators permit this type of arrangement provided there is a regulated intermediary in the foreign jurisdiction which executes the trade. The CSA are specifically requesting comment on issues related to foreign ATSs carrying on business in a jurisdiction.

Question 10:

Should the foreign ATSs 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 of the foreign ATS)?

Question 12:

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

(c) Order Routing and Remote Access

Some dealers may only act as order routers, which means the main service they provide is the technology which enables a customer to direct an order to a market for execution. While such activity still requires the dealer to comply with the same registration requirements as other registered dealers, the level of service can be quite different from a full service dealer. The dealer can be little more than a communication link.

CSA Staff are considering whether the nature of the activities of the dealer should have an impact on permitting remote access without any further regulation of the foreign ATS. For example, should the CSA permit remote access through a dealer that does not provide investment recommendations.

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?

CSA Staff are also considering whether the Home Jurisdiction Approach should be permitted if the only activity and purpose of a dealer is to direct orders from the customer to an ATS located in a foreign jurisdiction. Should the CSA allow a dealer to be set up as a Canadian subsidiary of the foreign ATS under a remote access model, or must the Canadian dealer be independent of the ATS?

Question 15:

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

Another example is the use of the international dealer registration in Ontario. CSA Staff is aware that foreign markets are attempting to provide access to their markets through foreign dealers which are registered as international dealers in Ontario. These international dealers route the orders to affiliates located in the foreign jurisdiction where the market is located. Although international dealers are limited in the scope of their activity, their regulatory requirements are also limited. The CSA are requesting comment on whether remote access should be permitted through international dealers or other categories of dealers which are not members of a self-regulatory organization.

Question 16:

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

B. TRADING RULES APPLICABLE TO ALL MARKETPLACES- SUBSTANCE AND PURPOSE

Currently, each of the established recognized exchanges have implemented trading rules which are designed to establish fair and equitable trade practices and to prevent abusive and manipulative trade practices. If ATSs are to be allowed to operate independently of recognized marketplaces, they must also follow similar trade practices for their marketplace participants. However, in a competitive environment, it is not appropriate that the rules for ATSs be set out by other marketplace participants. It is therefore necessary for the CSA to establish basic common trading rules that will apply across all marketplaces. National Instrument 23-101 Trading Rules ("Trading Rules") and Companion Policy 23-101CP sets forth common trading rules which will apply to trading on all marketplaces. The Trading Rules do not prohibit marketplaces from implementing additional rules.

The Trading Rules proposed address two significant areas of trading practice in our markets. First, they set forth the rules that will prevent participants from engaging in manipulation of prices or the creation of deceptive trading activity. For example, they establish short sale conditions. Short sales can be beneficial to the market as they can provide a stabilizing influence on market activity in order to prevent volatile price movement. In certain circumstances, however, short sales can be detrimental as they may be used as a tool for price manipulation. The short sale rule is intended to strike a balance between maintaining the beneficial aspects while at the same time preventing the detrimental aspects. Canadian exchanges have been applying different standards of short sale rules. The Toronto Stock Exchange, The Montreal Exchange and The Alberta Stock Exchange have used a "zero-minus tick" rule while the Vancouver Stock Exchange has used a zero-plus tick rule. The Canadian securities regulatory authorities consider that the higher standard of short sale rule, *i.e.*, the zero-plus tick rule, is appropriate to improve market stabilization and is also consistent with the current practices and rules adopted by U.S. markets.

The Trading Rules also set out standards for achieving best execution for customer orders and for ensuring that fair and ethical standards are applied across all markets. Specifically, they establish that participants' orders which are committed to the market must receive priority and prohibit the practice of crossing on the existing bid or offer without satisfying an order with previous standing. Further they prohibit customer client transactions under 10,000 shares unless the principal gives the client a better price than the order would have received in the existing market. The CSA were particularly influenced by the Report of Special Committee on Fragmentation produced by the TSE and concurred that the formulation of rules based on short term profit motives by member firms have eroded the price discovery mechanism in our markets and have serious implications for the stability of our capital markets.

C. THE CONSOLIDATION PLAN

General

The CSA believe that it is important to establish a framework that will allow competition between different marketplaces. However, it is also beneficial to maintain the benefits of having a centralized market. For this reason, in order to reduce the fragmentation caused by trading occurring in multiple marketplaces, it is critical to provide for consolidation of these marketplaces. The Consolidation Plan provides a detailed plan for consolidation, which will result in all investors having access to information across all marketplaces and all investors also having access to the best price available for execution across all marketplaces.

The Consolidation Plan proposes the establishment of a data consolidator who will be chosen by the CSA in response to a Request for Proposal ("RFP"). All marketplaces will be required to provide pre-trade and post-trade information to the data consolidator. The data consolidator will distribute a consolidated Canadian data feed based on the information provided by all of these marketplaces.

The Consolidation Plan further proposes that marketplaces be integrated in a phased process. Phase 1 of integration would require that each ATS be linked to a principal market for the securities that the ATS trades. Phase 2 would require that interlinkages between ATSs and the principal market(s) be accomplished through a market integrator (the "Market Integrator"). The Market Integrator may also be chosen through an RFP process following implementation of Phase 1.

The Consolidation Plan sets a framework for establishing a centralized market system which combines the positive benefits of new alternative technologies with traditional market structures.

Issues regarding consolidation

(i) After hours trading – restriction on price

During normal trading hours in the principal market, all participating exchanges, quotation and trade reporting systems and ATSs will send pre-trade and post-trade data to the data consolidator, subject to the trade-through policy. After market hours, ATSs will be allowed to operate and will be required to provide the data consolidator with quotation and transaction information. Several major U.S. markets have announced their intent to extend trading to evening hours. If they do, it is likely that Canadian exchanges would follow with similar changes.

The CSA are specifically requesting comment on two issues related to trading outside market hours:

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 trading 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?

The Consolidation Plan contemplates that the data consolidator be supervised by a governing committee. The CSA are proposing that the governing committee discuss and determine extended trading hours required, the content of data during those hours and accommodations required for market opening and system maintenance and/or scheduled downtime.

(ii) Depth of Market

Section 7.1 of the Instrument and the Consolidation Plan provide that consolidated data include the volume at each price level for the best five prices on the bid and offer for each marketplace. This is based on the current practice in Canada of displaying five levels of market by price for most exchanges. The CSA also considered the following alternatives: (a) display only the best bid and offer prices, as is the practice in the United States (the NBBO or National Best Bid and Offer); or (b) display of volume and price for the entire depth of the book.

Showing only the best bid and offer provides marketplace participants with less information since it shows only one price level on each side of the market. The NBBO approach is the one followed by the U.S. Securities and Exchange Commission and goes back to the development of the National Market System. The development occurred at a time when technology was less advanced and electronic books were not common among exchanges.

Showing the best five levels provides more complete information about the market and is consistent with historical practices in Canada. By limiting the display to five levels, marketplace participants in each particular system would still have access to the complete order book in their own system. In this way, there is still a benefit in membership in individual systems.

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?

(iii) Choice of Regulator Given Exchange Restructuring

Market regulation (rules, surveillance, and enforcement) has traditionally been provided by exchanges. However, in an environment with ATS systems competing with exchanges, a

mechanism for direct market regulation of ATSS must be established. Since ATSS will compete with exchanges, it will be necessary for the CSA to provide an overall structure that incorporates ATSS into the market oversight structure while not hindering the ability of ATSS to compete with exchanges.

Market regulation could be carried out by the CSA, an existing exchange, an existing SRO, such as the IDA, or a new SRO established for this purpose. A key issue in determining who takes on this role is which entities are best suited to perform this function and which entities have the best resources to successfully accomplish it. Another key issue is that market regulation not hinder the effective operation of any marketplace participant because of conflicts of interests.

The CSA have spent significant time discussing this issue. As a result of this careful review, and until there is another acceptable regulatory option in Canada, the CSA have formulated the following provisions for market regulation.

1. The CSA will adopt the Trading Rules, which will provide for a standardized and co-ordinated set of rules governing trade practices on all marketplaces carrying on business in Canada.
2. An ATS that chooses to be a member of the IDA, will be required to contract with an exchange of its choice for the exchange to provide surveillance and enforcement for the ATS. In this way, each ATS has some choice over the appropriate party to perform its surveillance while the exchanges have the opportunity to spread the costs of market oversight to the ATS for whom it performs this function. The CSA will be responsible for oversight of any conflict between exchanges and ATSS in the performance of these functions.
3. Where securities trade on multiple exchanges and are subject to regulatory oversight by multiple exchanges, those exchanges will be required to provide co-ordination of surveillance and enforcement activities on behalf of the ATS for the purposes of applying the Trading Rules across all participant systems.

The proposal as described above is based on the existing interlisted structure in Canada. However, if the exchanges' proposal for restructuring is adopted, then each issue will trade on only one exchange. This changed model has implications for regulatory oversight of ATSS. The CSA are specifically requesting comment on the following issues:

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.

(iv) Regulatory Halts

The CSA are considering whether it is appropriate to require an ATS to halt trading in a security when there is a regulatory halt imposed on the market where the security is listed or quoted. The CSA are suggesting that, during any regulatory halt, the data consolidator cease to disseminate information on that security until the halt has been lifted by the market where the security is listed or quoted and the security has entered a pre-opening period.

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?

D. SPECIFIC REQUESTS FOR COMMENT

In summary, the CSA specifically request comment on the following issues:

Question 1:

Is 40 percent 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 percent or 20 percent)?

Question 2:

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

Question 3:

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

Question 4:

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

Question 5:

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

Question 6:

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

Question 7:

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

Question 8:

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

Question 9:

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

Question 10:

Should the foreign ATSs 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 of the foreign ATS)?

Question 12:

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

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?

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 trading 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?

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?

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.

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?

Authority for the Proposed National Instruments and Proposed Forms

In those jurisdictions in which the Instrument, Trading Rules and Forms are to be adopted as rules or regulations, the securities legislation in each of those jurisdictions provides the securities regulatory authority with rule-making or regulation-making authority in respect of the subject matter of the Instrument, Trading Rules and Forms.

The Instrument and Trading Rules are being proposed for implementation in Ontario as rules. In Ontario, the following provisions of the *Securities Act* (Ontario) (the "Ontario Act") provide the Commission with authority to adopt the Instrument and the Forms as rules. Paragraph 143(1)1 authorizes the Commission to make rules prescribing

requirements in respect of applications for registration and the renewal, amendment, expiration or surrender of registration and in respect of suspension, cancellation or reinstatement of registration. Paragraph 143(1)2 authorizes the Commission to make rules prescribing categories or sub-categories of registrants, classifying registrants into categories or sub-categories and prescribing the conditions of registration or other requirements for registrants or any category or sub-category. Paragraph 143(1)7 authorizes the Commission to make rules prescribing requirements in respect of the disclosure or furnishing of information to the public or the Commission by registrants. Paragraph 143(1)10 authorizes the Commission to make rules prescribing requirements in respect of the books, records and other documents required by subsection 19(1) of the Ontario Act to be kept by market participants (as defined in the Ontario Act), including the form in which and the period for which the books, records and other documents are to be kept. Paragraph 143(1)11 authorizes the Commission to make rules regulating the listing or trading of publicly traded securities including requiring reporting of trades and quotations. Paragraph 143(1)12 authorizes the Commission to make rules regulating recognized stock exchanges, recognized self-regulatory organizations, and recognized quotation and trade reporting system including prescribing requirements in respect of the review or approval by the Commission of any by-law, rule, regulation, policy, procedure, interpretation or practice. Paragraph 143(1)13 authorizes the Commission to make rules regulating trading or advising in securities to prevent trading or advising that is fraudulent, manipulative, deceptive or unfairly detrimental to investors. Paragraph 143(1)39 authorizes the Commission to make rules requiring or respecting the media, format, preparation, form, content, execution, certification, dissemination and other use, filing and review of all documents required under or governed by the Ontario Act, the regulations or the rules and all documents determined by the regulations or the rules to be ancillary to the documents.

In Ontario, the following provisions of the Ontario Act provide the Commission with authority to adopt the Trading Rules as a rule. Paragraph 143(1)2 authorizes the Commission to make rules prescribing categories or sub-categories of registrants, classifying registrants into categories or sub-categories and prescribing the conditions of registration or other requirements for registrants or any category or sub-category. Paragraph 143(1)11 authorizes the Commission to make rules regulating the listing or trading of publicly traded securities including requiring reporting of trades and quotations. Paragraph 143(1)12 authorizes the Commission to make rules regulating recognized stock exchanges and recognized quotation and trade reporting systems. Paragraph 143(1)13 authorizes the Commission to make rules regulating trading or advising in securities to prevent trading or advising that is fraudulent, manipulative, deceptive or unfairly detrimental to investors.

In Ontario, paragraph 143(1)40 of the Ontario Act provides the Commission with authority to adopt Rule 23-501 as a rule. Paragraph 143(1)40 authorizes the Commission to make rules respecting the designation or recognition of any person, company or jurisdiction if advisable for the Ontario Act,

including designating a person or company for the purpose of the definition of "market participant".

Related Instruments

The Instrument and Policy are related to each other as they deal with the same subject matter. In Ontario, the Policy is related to Part VII, Part VIII and Part XI of the Ontario Act and Part V of the Regulation to the Ontario Act.

The Trading Rules and Trading Rules Policy are related to each other as they deal with the same subject matter. In Ontario, the Trading Rules Policy is related to Part VIII of the Ontario Act.

Alternatives Considered

The Instrument provides an appropriate framework for the regulation of ATSS. Accordingly, no alternatives were considered to the adoption of the Instrument. Similarly, once ATSS begin operating in Canada, the Trading Rules are also necessary as ATSS are not allowed to set requirements governing member conduct. Consequently, no alternatives were considered to the adoption of the Trading Rules. No alternatives were considered to the adoption of Rule 23-501.

Unpublished Materials

In proposing the Instrument, the Policy, the Trading Rules, Trading Rules Policy and Rule 23-501, the CSA have not relied on any significant unpublished study, report, decision or other written materials.

Anticipated Costs and Benefits

The Instrument allows ATSS to compete with traditional markets, such as exchanges. When an environment is established that allows for competition among markets, then investors will have choices. The CSA are of the view that allowing such competition will stimulate innovation and encourage markets to offer better features and services to their members and subscribers and at lower costs. The Consolidation Plan will combine the positive benefits of competing systems while preserving the benefits of a centralized market.

The Instrument also provides improved market transparency for all marketplaces as well as interlinkage of those marketplaces so that all buyers and sellers of a security have access to the best price for execution.

The requirements regarding systems capacity, integrity and security of systems provide several benefits to the marketplace and to investors. Marketplaces are increasingly reliant on technology and most of their functions are becoming highly automated. The ability of marketplaces to provide more reliable and consistent service in the market benefits investors and the markets.

The Instrument imposes costs on ATSS, exchanges and quotation and trade reporting systems as a result of the

requirements imposed by the proposed Instrument, including application procedures, access requirements, the requirement to adopt certain by-laws and rules, the requirements relating to pre-trade and post-trade transparency and market integration, and the requirements relating to capacity, integrity and security of systems. In particular, the notice, reporting and recordkeeping requirements will require marketplaces to file certain additional information. The requirements relating to capacity, integrity and security will also impose costs. However, smaller ATSS will not be subject to the requirements relating to capacity, integrity and security of systems.

In the view of the CSA, the benefits outweigh the costs.

The Trading Rules benefit purchasers and sellers of securities in that they are designed to prohibit certain practices and to require other practices, all of which are necessary for the operation of fair and efficient capital markets. The Trading Rules impose compliance costs on persons or companies subject to the Trading Rules in that it prohibits certain activities. It also imposes costs on marketplace participants in terms of the best execution rules and the rules restricting principal trading. It also requires marketplaces to monitor and enforce compliance with certain of the provisions of the Trading Rules. In the view of the CSA, the benefits of the Trading Rules outweigh the costs.

Rule 23-501 will impose costs on a recognized quotation and trade reporting system as it will be subject to the market participant requirements of the Ontario Act. Rule 23-501 will benefit participants in the Ontario capital markets by making quotation and trade reporting systems subject to the market participant requirements in the Ontario Act. There is no reason to distinguish between recognized quotation and trade reporting systems and other participants.

Regulations to be Amended

In Ontario, the Commission intends to amend s.128 and s. 154 of the Regulation to the Ontario Act to allow for the purchase or sale of a security through the facilities of an ATS.

Comments

Interested parties are invited to make written submissions with respect to the Instrument, Policy, Forms, Trading Rules, Trading Rules Policy and Consolidation Plan . Submissions received by October 1, 1999 will be considered.

Submissions should be sent to all of the Canadian securities regulatory authorities 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
Registrar of Securities, Northwest Territories
Registrar of Securities, Yukon Territory
Registrar of Securities, Nunavut

c/o Daniel P. Iggers, Secretary
Ontario Securities Commission
20 Queen Street West
Suite 800, Box 55
Toronto, Ontario M5H 3S8
E-mail: diggers@osc.gov.on.ca

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

Claude St. Pierre, Secretary
Commission des valeurs mobilières du Québec
800 Victoria Square
Stock Exchange Tower
P.O. Box 246, 22nd Floor
Montréal, Québec H4Z 1G3
E-mail: claudestpierre@cvmq.com

A diskette containing the submissions (in DOS or Windows format, preferably WordPerfect) should also be submitted. As securities legislation in certain provinces requires that a summary of written comments received during the comment period be published, confidentiality of submissions cannot be maintained.

Questions may be referred to any of:

Louyse Gauvin
Executive Assistant to the Chair
British Columbia Securities Commission
(604) 899-6538 or (800) 373-6393 (in B.C.)

Robert Hudson
Manager and Senior Legal Counsel
British Columbia Securities Commission
(604) 899-6691 or (800) 373-6393 (in B.C.)

Ross McLennan
Director, Registration
British Columbia Securities Commission
(604) 899-6685 or (800) 373-6393 (in B.C.)

Eric Spink
Vice-Chair
Alberta Securities Commission
(780) 422-1503

Glenda Campbell
Director, Legal Services & Policy Development
Alberta Securities Commission
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(416) 593-8257

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(416) 593-8140

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Consultant, Market Regulation
Ontario Securities Commission
(416) 593-3669

Diane Joly
Director, Research and Market Development
Commission des valeurs mobilières du Québec
(514) 940-2199, ext. 4551

CSA Staff would like to thank Hugh Cleland for his guidance in the early stages of this project.

Proposed National Instruments, Companion Policies and Form

The text of proposed National Instrument 21-101, proposed Companion Policy 21-101CP, proposed Forms 21-101F1, 21-101F2, 21-101F3, 21-101F4, and proposed National Instrument 23-101 and proposed Companion Policy 23-101CP follow, together with footnotes that are not part of the proposed National Instruments, Companion Policies and Forms, as applicable, but have been included to provide background and explanation.

**Appendix A to the Notice
“Regulation of Alternative Trading Systems in Canada”**

Appendix A:

Section 1: EXECUTIVE SUMMARY

REGULATION OF ALTERNATIVE TRADING SYSTEMS IN CANADA

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Significant discussion and debate has been carried out for over ten years on the appropriate regulatory framework under which Alternative Trading Systems (“ATSS”) should be allowed to operate in Canada. This paper presents a brief history of the events regarding ATSS and attempts to summarize the key issues on this topic.

As the investment industry has evolved in recent decades, technology has been a major influence on the nature of business operation. Academic analysis on the effects of technology has concluded that it provides great benefits for investors, increasing competition and providing greater transparency of markets.

In Canada, ATSS have been allowed to operate in a restricted fashion. Concerns over market fragmentation have resulted in ATSS being limited to operation only as members of an existing exchange. However, most market participants believe that the time has come to allow ATSS to compete with traditional exchanges.

In assessing this issue, Canadian regulators have been particularly cognizant of recent developments in US markets, where the SEC has recently adopted new rules that permit ATSS to register as either exchanges or dealers, and further require that ATSS be linked to the National Market System. While Canada has several specific issues which need to be addressed, Canadian regulators have been particularly interested in US developments and believe that it is appropriate to follow a model closely based on the US approach.

In this paper, close attention was given to the attributes of ideal markets and to how these attributes could be applied in the Canadian context, to deal specifically with the issues of concentration, fragmentation and the future role of traditional exchanges.

The Canadian Securities Administrators (“CSA”) is setting forth, in National Instrument 21-101 “Marketplace Operations” and National Instrument 23-101 “Trading Rules”, a regulatory framework for marketplaces, which will combine these new markets based on technology, with traditional market structures.

Section 2: BACKGROUND

Alternative Trading Systems (“ATSS”) are Electronic Trading Systems (“ETSS”).¹ ATSS provide automated matching systems, which bring together orders from buyers and sellers, by using predetermined,

¹ Electronic Trading System is the general term used to describe computer systems that automate all or part of the trade process. They may provide order routing between clients, brokers and/or exchanges or they may perform the execution matching typically provided by exchanges.

established methods or rules under which such orders interact. They may operate a continuous auction book, a dealer market, a call market, or an anonymous match based on a price determined by the principal market. ATs have gained great appeal in a number of market segments, primarily because they have features and services not typically offered by traditional exchange markets. They have previously been referred to as Non-Exchange Trading Systems ("NETS") and Proprietary Electronic Trading Systems ("PETS").

Over the past decade, regulators in both Canada and the US have undertaken extensive research and review of electronic trading in order that they may establish an appropriate framework of regulation for ATs and incorporate these new systems into traditional market structures. This paper sets out the history of ATs and discusses the issues they raise for discussion in more detail.

2.1 Alternative Trading Systems in Canada

In 1988, Instinet Canada Limited ("ICL")² purchased a seat on The Toronto Stock Exchange and applied for TSE membership. A group of TSE member firms strongly opposed Instinet's admission to membership and, following extensive discussions between the TSE and ICL, the Ontario Securities Commission ("OSC") was asked to intervene. In 1989, the OSC ruled that Instinet should be admitted to membership and that the TSE should appoint a Rule Review Committee to examine changes required to improve market quality and limit market fragmentation due to Instinet's inclusion. Instinet was restricted from installing terminals in Canada while the Rule Review Committee study was being conducted.

Subsequent to the Report of the Rule Review Committee, the OSC agreed to maintain the status quo provided that the TSE make the necessary rule changes recommended in the Report³ and prepare an in-depth study of the market fragmentation issue. The Commission confirmed ICL's TSE membership and registration as a broker, subject to the same restrictions imposed by the earlier ruling.⁴ Instinet commenced operation as a TSE member in 1993, but

was not permitted to install terminals on customers' desks in Ontario.

In May 1994, the OSC published a paper entitled "Electronic Trading Systems in Ontario" and in June 1994, sponsored a Forum to discuss the issues regarding NETS.

In early 1995, Versus Brokerage Services Inc. ("BSI"), a subsidiary of Versus Technologies Inc. ("VTI") was registered as a broker. Under TSE Policy XXX,⁵ VTI offered a terminal network permitting member firms, as well as institutions and foreign dealers to route orders to the TSE. VBSI participated in the network as a TSE member broker. In addition, Versus offered institutional clients the opportunity to participate in an electronic call (The Canadian Call) which is a call market facility integrated with the primary Canadian exchanges.

In September 1995, Instinet Corporation was granted registration by the OSC as an International Dealer, permitting it to provide terminals to institutions in Ontario to trade foreign listed securities, which were not interlisted on any Canadian exchange. The exchanges challenged this ruling and requested a formal hearing on the subject. The OSC denied requests from the major Canadian exchanges to hold a hearing on the matter and further determined that a formal process should be put in place to obtain meaningful comment on the issue of fragmentation.

In January 1997, the TSE published its long awaited Report of the Special Committee on Market Fragmentation⁶, ("the SC Report"), analysing the extent of fragmentation of equity markets in Canada. The SC Report analysed the causes and effects of fragmentation on the Canadian equity market. The report concluded that consolidated markets provide the highest quality, but that it is not always possible to satisfy the needs of different participants with one market structure. It further concluded that one of the most serious impacts from fragmentation was due to the "excessive diversion of smaller orders away from the TSE's auction market."⁷ The SC Report recommended that ATs be permitted to operate immediately as TSE members. The report further stated that it was inevitable that ATs would be allowed to operate as competitors and that the TSE should take a leadership role in establishing an

² Instinet Canada Limited is a subsidiary of Instinet Corporation, a wholly owned subsidiary of Reuters Group PLC.

³ Since that time, the TSE has adopted most of the changes but did not make one of the most significant changes that dealt with the cross interference rule.

⁴ ICL could serve Canadian accounts in Canadian and foreign securities but its customers were required to telephone orders to the ICL trading desk, where traders then keyed the orders into the Instinet system.

⁵ TSE Policy XXX allows designated financial institutions to directly input their orders to a TSE member firm's order routing system. Designated institutions are defined under Policy XXX.

⁶ TSE Special Committee Report, Market Fragmentation: Responding to the Challenge, Jan. 1997

⁷ TSE Special Committee Report, Market Fragmentation: Responding to the Challenge, Jan. 1997, p.39

appropriate framework under which they should be allowed to operate.

The OSC published a Request for Comments and Notice of Forum on the subject. Subsequently, the British Columbia Securities Commission ("BCSC"), the Alberta Securities Commission ("ASC"), the Saskatchewan Securities Commission ("SSC"), and the Commission des valeurs mobilières du Québec ("CVMQ") notified the OSC that they would like to participate in the meeting. The Forum was held in April 1998, and was presided over by the Chairs of the OSC, BCSC, ASC, SSC and CVMQ. Upon consideration of the comments at the Forum, responses to the request for comments, developments in other jurisdictions (particularly the SEC Rule on ATs) and further discussions with market participants, the CSA is publishing today Proposed National Instrument 21-101, Marketplace Operations, and the Companion Policy 21-101CP as well as Proposed National Instrument 23-101, Trading Rules, and the Companion Policy 23-101CP.

2.2 ATs in the United States

The CSA has followed developments on this issue in the US markets. The CSA has benefited from the research and analysis done by the Securities and Exchange Commission ("SEC") and from discussions on key issues with the SEC. The CSA has attempted to develop an approach that is consistent with the SEC approach while also taking into account specific differences in the Canadian market.

Canadian exchanges are profoundly influenced by events occurring in the US markets. Over 200 Canadian companies are interlisted between Canadian and US markets and Canadian issuers increasingly look to US markets for listing. Because of their leadership role and their size relative to Canadian markets,⁸ developments in the US have a significant influence on market structure issues in Canada. ATs and their regulation, is one of several key issues that reflect the continuing evolution of markets and is a topic which the Canadian investment community has followed and debated in great detail.

Although Canadian markets have historically been highly automated in the trade match and execution process,⁹ automation of the entire trade process has evolved more rapidly in the US. Specifically, the establishment of a variety of alternative forms of trading systems has led the SEC to continually effect

changes to accommodate an evolving market structure.

In the early 1970's, the SEC was dealing with a number of issues concerning regional exchanges, the growth of institutional pools of funds and issues related to the applications of technology. In 1975, the SEC enacted the Securities Act Amendments Act of 1975, which dealt with matters regarding competition between market centres and the benefits of technology.

The principal objective of the Act was to provide for "equally regulated, individual markets which are linked together to make their best price known and accessible."¹⁰ It directed that a National Market System ("NMS") be established, to provide for fair access to market information and for the linking of markets. The establishment of a NMS¹¹ ensured that all participants would have access to information regarding the volume and price of bids and offers in all markets and that a National Best Bid and Offer (NBBO) would be published by vendors. Further, all participants would have access to "best execution" of their order, at the best bid or offer price across all markets. The Act also provided the SEC with the authority to regulate and oversee securities information processors (such as SIAC and NASDAQ).

Finally, and perhaps most importantly, it established that the use of technology to provide transaction services that might challenge traditional exchanges and their members not be discouraged. To this end, it required the NYSE and AMEX to remove rules which required that their members must make all trades in listed securities on the exchange.

Following the implementation of the NMS, the SEC was faced with the question of how to register computer-based networks that were designed to bring together and match buying and selling interests. In order to foster competition and to allow for the development of these new systems, the SEC chose to register them as broker-dealers, rather than as exchanges. Regulation 17a-23 identified such systems as Electronic Communications Networks ("ECNs")¹² and required them to keep certain records in addition to those normally kept by broker-dealers.

From 1979 until the early 1990's, ATs were targeted at institutional investors and captured increasing trading volumes, primarily in NASDAQ issues.

⁸ The NYSE has \$8.9 trillion (US) in capitalization, NASDAQ has \$1.7 trillion (US) while the TSE, Canada's largest exchange has \$0.6 trillion (US).

⁹ All Canadian exchanges operate totally automated electronic book systems rather than traditional open outcry trading floors. The TSE closed its trading floor in April 1997.

¹⁰ Securities and Exchange Commission Release No. 34-40760, Regulation of Exchanges and Alternative Trading Systems, P.8

¹¹ The NMS has three components: the Consolidated Tape, the Consolidated Quotation System and the Intermarket Trading System.

¹² ECNs are ATs which both match orders internally and connect to other markets for execution.

Institutions were permitted to trade as subscribers in ATs and exchange members were able to participate based on Rule 19-c3¹³.

In 1996, the SEC announced new rules regarding the handling of retail orders in US markets. The order handling rules required that:

- (a) all client limit orders better than the NBBO must be displayed
- (b) limit orders be displayed by specialists in their quote, and
- (c) market makers display the price of any orders that they enter into alternative systems that are not available to investors in general.

Since the changes effected by the order handling rules, the growth of trading in ECNs in US markets has grown at a tremendous pace. By the end of 1998, there were 9 major ECNs in operation (and another 30 smaller ones) which collectively traded over 12 billion shares in 1998. Latest estimates indicate that they account for as much as 35% of orders in NASDAQ and close to 8% of orders in listed securities.¹⁴

Until recently, ATs essentially operated outside the exchange and National Market Systems. Their increasing popularity and growth led the SEC to further clarify the role of ATs in US markets and how they should be incorporated into the regulatory structure.

In December 1998, the SEC published its final rule regarding the regulation of ATs, adopting a regulatory framework that would balance a centralized market with competition. The final rule gave ATs the choice to register as exchanges or to register as broker-dealers and comply with Regulation ATS. ATs which trade more than 5% of the volume in NMS securities must be registered as a broker-dealer with an existing SRO and they must be linked with a registered market in order to disseminate their best priced orders into the public quote display. In addition, they must comply with the same market rules governing execution priorities that apply to members of registered exchanges. The SEC enacted these rules to "more effectively integrate the growing number of alternative trading systems into the national market system" and also to "provide an opportunity for registered

exchanges to better compete with alternative trading systems."¹⁵

2.3 Industry Trends

The debate regarding ATs has taken place in the context of rapidly changing capital markets, not only in Canada, but also around the world. Market participants face a number of trends, which are changing the way investors participate in the market, and, in particular, the manner in which they transact their business.

2.3.1 Technology

Without question, technology and its applications has been one of the single greatest influences on capital markets over the past decade. Rapid changes in technology have had a profound impact on the nature of business operations. Evolving technologies in hardware, software applications and communications since the early 1980's have impacted capital markets and the rate of change continues to accelerate. Applications of technology to the trading process have given rise to totally electronic markets that are seamlessly integrated with order management systems as well as clearing and settlement systems. These markets now operate with increased efficiencies, able to transact unprecedented volumes at ever-increasing speeds. While these efficiencies have led to improved products and services for customers, they have also resulted in lowering the overall costs of transactions.

In addition to improvements to the efficiency of transactions, technology has provided investors with greater access to information about securities and the markets on which they trade. Advances in communications have reduced geographical boundaries, giving investors access to markets once separated by physical location. As a result, technology has enabled competition to develop that challenges the traditional structure of capital markets.

2.3.2 Globalization

As investors have been able to access greater choice among markets, technology has led to increased globalisation of investment. Companies seeking to raise capital are no longer bound to local jurisdictions and have sought to raise capital in markets that offer them the greatest benefit. So, too, investors faced with increased choices have sought to improve their rates of return by investing in markets that offer the greatest opportunity for growth and development, regardless of geographical location.

¹³ Rule 19c3 provides that member firms may not be prohibited from trading off-exchange; US exchanges cannot require that members place agency orders in any listed security on the exchange. With respect to bids/offers made as principal, the exchanges were permitted to retain the prohibition on off-exchange trading for securities listed prior to April 26, 1979.

¹⁴ R. Buckman and A. Lucchetti, *Electronic Networks Threaten Trading Desks on Street*, Wall Street Journal, Dec. 23, 1998

¹⁵ Securities and Exchange Commission Release No. 34-40760

2.3.3 Institutional Consolidation

As a result of deregulation in financial service sectors, large financial service organizations now offer a breadth of financial services to investors and the distinction between the four pillars of finance (banking, trust, brokerage and insurance) has blurred. These new organizations operate large pooled funds on behalf of their customers, creating markets that are now dominated by institutional participants. Technology has also enabled growth in both the breadth of products offered and the growth of the large pooled funds. Index funds, global diversified funds, and quantitative funds operate large pooled funds based on technology.

In the US, in the last 5 years, capital under management has risen from \$500 billion to over \$4 trillion. The Toronto Stock Exchange, in its recent Blueprint For Success noted that "share ownership by institutional investors in Canada increased in the last 15 years from approximately 50% to an estimated 80% of the total equity market." The result has been that institutional traders must manage orders with great care and that market impact costs far exceed commission costs.

2.3.4 Challenges to the Traditional Role of Intermediaries

The changes brought about by technological innovation have provided investors with greater choice than ever before. This innovation has established new and improved methods of operation and threatens traditional market structure and processes. As investors have gained greater access to markets and information, they have become less reliant on the traditional intermediary function supplied by brokerages. Traditional roles which brokers played have become replaced by technology. Research, once reserved for a broker's own client base, is now readily available from a variety of sources on the Internet. Indeed, brokers themselves have made access to their proprietary research readily available. Market information, once available only to investment professionals from market data vendors, is now provided free of charge by vendors, brokers and other information providers. Finally, in recent years, access to both primary markets and secondary markets has become commonplace using technology. The growth of discount trading and access to ECN networks¹⁶ has allowed individual investors to effect their transactions with virtually no intermediation by brokers.

Institutional investors, who are seeking to match large block trades, are no longer satisfied with the traditional intermediation provided by block traders at investment

¹⁶ ECNs, or Electronic Communications Networks, such as Island, BRUT, and Archipelago offer retail investors the ability to enter orders which may be matched against other retail orders in their own trade system or routed to another market, such as NASDAQ for display in the NMS.

firms. Managers of large block trades now seek the ability to manage their trade execution directly and to minimize market impact costs.¹⁷ According to studies carried out by Plexus Group,¹⁸ more than two-thirds of original institutional desk orders for a given stock exceed half of that stock's daily volume. The liquidity previously provided by brokers, acting as principal, has not kept up with the growth of large institutional orders. Institutional traders want to be able to find counterparties to their trades in systems that provide anonymity and do not force them to reveal the full size of their order to find the opposite side.

2.3.5 Challenges to Traditional Exchange Structures

As regulators respond to providing a framework to incorporate alternative markets, the traditional monopoly position that most exchanges have held is no longer tenable or practical. Faced with increasing competition from these alternative markets, exchanges around the world are seeking ways in which to improve their efficiency and attract participants to their markets. The rise of alternative types of markets has also led market participants to question what constitutes an exchange and what functions are intrinsic to its operation. In order to be more competitive, traditional exchanges have studied a number of changes to the way in which they operate to make them more competitive. First, exchanges have sought to merge or consolidate with other exchanges and benefit from combined liquidity and increased operational efficiencies. Second, many exchanges are moving towards demutualization and establishing a public/private corporate structure as opposed to a membership based organization. They are also seeking to provide access to institutional investors in more direct ways than ever before, whether by offering direct trading access to their market, by offering new market facilities such as OptiMark¹⁹, or through changing the ownership structure to broaden the scope of participation.

Section 3: An Ideal Market Structure

3.1 Attributes of an Ideal Market

The strength and viability of a capital market are essentially dependent on two principal functions: first,

¹⁷ Market Impact is defined as the negative effect on the price of the stock caused by market knowledge of a large order to buy or sell.

¹⁸ Plexus Group is a consulting group which specializes in measuring the cost of transactions for institutional investors.

¹⁹ The OptiMark system operates as a facility of an exchange, and offers an anonymous, non-disclosed call market, incorporating the exchange book with large block orders entered directly by institutions. OptiMark currently is in operation at the Pacific Coast Exchange and has agreements to license their technology with Nasdaq, Osaka and The Toronto Stock Exchange.

the ability to support financing of enterprises by raising capital in the primary market and second, the ability to value publicly traded assets accurately and efficiently in the secondary markets. To the extent that market structure supports these fundamental functions, that market structure will provide for a capital market that meets the needs of market participants. In determining the appropriate overall structure in the Canadian context, the CSA's objective has been to ensure both public confidence in the marketplace and investor protection.

The issues surrounding market structure and how best to achieve an ideal market have been studied in recent years both in Canada and in the US by a number of market participants and academics. The TSE, in its Report of the Special Committee on Market Fragmentation, published in 1997, adopted a model (known as the Kirzner Model)²⁰ which set forth a framework describing the attributes of an ideal market. These attributes were defined to be Immediacy, Liquidity, Transparency, Price Discovery, Fairness, Integrity of the Credit Ring and Integrity of the Market. This model has been used in much of the debate in this country on the appropriate framework for ATSS and exchanges to operate.

In examining this model and much of the other market structure theory, the characteristics of an ideal market essentially fall into two broad categories, "Integrity of the Market" and "Efficiency of the Market". All of the attributes described in the Kirzner model fall within these broad categories, with certain attributes having a higher value and greater impact than others.

3.1.1 Integrity of the Market

The Integrity of the Market will be dependent on public confidence and perception that the market operates in a fair and ethical manner. Investors and the public, in general, must believe that all participants have equal access to accurate and timely information about the issues being traded. Marketplaces that have a high level of integrity will have effective practices regarding disclosure of issuer information to all participants.

Participants must believe that they are not unfairly discriminated against, as compared to any other set of participants (including insiders) in their ability to effect transactions in the marketplace. The marketplace will have rules that are perceived to apply fair and equitable principles by which transactions are executed, once again, serving all participants equally. In addition, information concerning orders and transactions in the

marketplace must have a high degree of transparency. Markets are determined to be transparent when they make information about orders (pre-trade) and transactions (post-trade) in the marketplace available to the public on a real-time basis, so that all participants have equal access to accurate and timely information.

Finally, participants must also have a high degree of trust that transactions in the marketplace are being executed through trustworthy counterparties and that the transaction will be completed and settled in a satisfactory manner (this is generally referred to as the Integrity of the Credit Ring).

3.1.2 Efficiency of the Market

The Efficiency of the Market refers to the ability of any participant to be able to execute a transaction quickly and easily, at a price which accurately reflects supply and demand with minimum transaction costs. In terms of the Kirzner model, this means that the market must have immediacy, liquidity, an effective price discovery mechanism and low transaction costs.

Immediacy will mean that a transaction can be effected quickly; i.e., that a transaction can be executed in a relatively short period of time without negatively impacting the price received. This concept is closely linked with liquidity which is normally described as the ability to purchase or sell a security at or near the last sale price and will be dependent on the depth, breadth and resiliency of the market. When a market does not have liquidity and immediacy, transactions become difficult to execute and/or result in price volatility which produces inefficient pricing for participants.

When a market has an effective price discovery mechanism, buyers and sellers are able to execute their transactions at prices that accurately reflect true supply and demand as well as the market's assessment of the value of the security. Typically, price discovery mechanisms fail when there is unequal information disclosure among participants, when the price is determined based on incomplete information about supply and demand or when one or more parties are able to engage in fraudulent or manipulative practices.

Finally, an efficient market is one in which participants are able to execute transactions at minimum cost. Transaction costs are typically measured in terms of the transaction fee charged (which may be either the brokerage commission or dealer mark-up charged) and the market impact cost. Market impact is generally believed to be the more significant (and often hidden) component of the transaction cost; it is normally defined as the difference between the market price of the security before an order was placed and the price received for execution upon completion of the order. While transaction fees have been driven steadily lower in recent years as a result of the deregulation of

²⁰ The ideal market model was named for Eric Kirzner, Professor of Finance at the University of Toronto, and who acted as Chairman of the Special Committee

commission rates and through efficiencies derived from technology, market impact costs have risen dramatically. Market impact costs have risen due to the growth of institutional holdings and the increasing difficulty in effecting large block transactions.

3.2 Academic Analysis/Viewpoints

As regulators have sought to respond to the ever-increasing use of technology in the investment industry, their primary goal has been to address issues of competition and investor interest. To a large extent, they have been motivated by the anticipation of important opportunities that might be provided by emerging technologies.

Heated public discussion around the appropriate regulatory structure, which would incorporate these technologies into the traditional market structure, has generated academic literature focussed on securities markets and market structure. The impact of technology on securities markets and on the role of brokers and dealers has also generated a number of academic studies. The results of these studies have brought into question many of the conventional assumptions about the appropriate structure of exchanges and other markets, as well as the appropriate regulatory environments.

Analytic and empirical studies have focussed on topics as broad as market fragmentation and price discovery to narrower ones such as the price/time priority, the nature of limit orders, and minimum spreads. The following summarizes some of the key topics discussed by academics that are relative to the discussions around the attributes of an ideal market and the appropriate market structure to support this market.

3.2.1 Benefits of Electronic Trading

Academic analysis is universally in favour of the changes brought about by the application of technology to the trade process and, in particular, to electronic trading. Peake, Mendelson and Williams did the first comprehensive analysis on the topic of computer-based trading in 1976.²¹ This study proposed a national electronic book and greatly influenced future developments in electronic trading systems. One of the first exchange computer trading systems was the CATS system,²² developed by the TSE and implemented in 1977. CATS was adopted by many

other exchanges including Paris, Madrid, and Brussels, and was used as the model for other systems for many years.

Benefits based on the use of electronic trading systems include:

- Ability to handle increased levels of volumes
- Ability for markets to compete over geographical boundaries
- Increased transparency of information
- Expanded dissemination of information
- Increased access to markets
- The seamless execution of the trade process from the point at which the investment decision was made to the completion and settlement of the trade

In addition to these benefits, electronic trading has also been a key factor, in enabling new types of trading to develop; specifically, trading in derivatives, as well as program and basket trading. Electronic trading is believed to have contributed to the huge growth of pooled funds that dominate the market. In recent years, electronic trading has given rise to alternative markets, which challenge traditional markets, such as exchanges, and have provided market participants with new products, features and services not typically offered by traditional exchanges.

3.2.2 Appropriate Implementation of Systems

When technology has been applied to the trade process, the most successful implementations have involved a reworking of the business processes themselves. Effective applications of technology should not merely replace the steps once carried out in a manual process. The development of trading systems has been a learning process for markets and for participants alike. Business processes must change to incorporate new systems and to achieve the maximum benefit that technology offers.

This issue is discussed by Amihud and Mendelson who further believe that markets must not only re-engineer the process and procedures but must also go about development in a thoughtful, cohesive fashion, determining an overall architecture for trading systems which takes into account ongoing needs for future enhancement. They contend that exchanges have largely approached automation in an unplanned, unsynchronised manner, resulting in high costs of development and onerous barriers to entry. "The piecemeal development of Exchange's automated systems and the lack of a well-planned integrative approach impose a very high cost on trading institutions that interface with the Exchange's

²¹ The study, "Towards a Modern Exchange: The Peake-Mendelson-Williams Proposal for an Electronically Assisted Auction Market", by Junius Peake, Morris Mendelson and R.T. Williams was published in *Impending Changes for Securities Markets: What Role for the Exchanges*, E. Bloch and R. Schwarz, JAI Press, 1979.

²² CATS stands for Computer Assisted Trading System.

systems.”²³ As technology has changed rapidly over the years, exchanges have been forced to make changes to systems designed to meet long outdated demands.

3.2.3 Competition

The academic literature strongly suggests that competition has been a positive factor for the investment industry and that, in particular, challenges from ATs to traditional exchanges have important benefits for investors. Traditional structures such as exchanges have had strong incentives to resist technology and innovation, which might decrease their intermediary power. Several studies point out that the role of the regulators should be to establish a framework that will allow competitive markets and engenders competition between various trading environments. In its Market 2000 report, the SEC pointed out that “competition among these market centres provides many benefits for the users of the markets.”²⁴ Further, in response to exchanges’ fears that multiple markets would lead to fragmentation, the SEC countered that “dispersion of order flow among market centres has not impaired price discovery or market quality”.²⁵ Competition has forced exchanges to be more responsive to the needs of market participants and has enabled technological innovation to move forward.

3.2.4 Market Microstructure

In recent years, great consideration has been given to the specific processes used within one market as opposed to another and the effect that those processes have on the overall quality of the market. Many academics have suggested that markets must be re-engineered and redefined based on technology and have chosen to refer to this approach as “technostructure”. It is clear that a number of elements used in the systems design of a market will impact the effectiveness of that market.

As an example, when the TSE first developed its pioneer CATS trading system, trading rules were defined specifically to take advantage of the new technology and rules were based on a strict price/time priority. While on a manual floor, it was often difficult to determine who had arrived at the post first (hence the common practice of sharing stock or pro-rating), in

a computer system, it was always possible to determine which order had entered the market first (if even by a millisecond). Market theorists believe that the advent of trading systems based on strict price/time priority provide a vastly more efficient market and offer wide access to unsubsidised liquidity providers, thus diminishing the need for traditional market maker roles.²⁶

In general, markets will have improved quality, meaning a greater degree of liquidity and immediacy, when their structure encourages participants to place orders in their electronic book. Markets which provide no benefit to being in the system first will find, over time, that participants will hold back orders and will develop other ways of matching trades (as for example, in an “upstairs” market).

Section 4: Market Structure

4.1 Objectives

In assessing the appropriate framework for a revised market structure, it is important to determine the role that the regulator should play. Industry participants generally contend that the appropriate role for the regulator is to provide an environment that fosters innovation and competition, thus letting competitive forces drive the evolution of market structure. The regulator should not try to define the perfect market structure but should allow healthy competition among participants to foster innovative developments that will benefit investors. The CSA agrees with the approach taken by the SEC in its Market 2000 Report, which sets forth that the principal duty of the regulator is to “cultivate an atmosphere in which innovation is welcome, without dictating a particular structure”.²⁷

Historically, exchanges were established to provide a facility for buying and selling interests to interact. Brokers, acting on behalf of the buyers and sellers, met in a central location, which provided a price discovery mechanism. When demand and supply were not always evenly matched, the custom of providing intermediaries such as jobbers or specialists became common in order to provide immediacy for participants. Securities legislation developed in North America to provide a framework for these exchange structures. However, in the last twenty years, technology has provided capabilities and services not envisioned when securities legislation established the traditional exchange structures.

Securities legislators are now faced with the task of allowing competition to traditional markets and allowing innovation based on technology to develop.

²³ Yakov Amihud and Haim Mendelson, “Liquidity, Volatility and Exchange Automation”, *Journal of Accounting, Audit and Finance*, Volume 3, Fall 1988.

²⁴ Securities and Exchange Commission, *Market 2000 Report*, January 1994

²⁵ Securities and Exchange Commission, *Market 2000 Report*, January 1994.

²⁶ H.R. Stoll, *Affirmative Obligation of Market Makers: An Idea Whose Time Has Passed?*, Vanderbilt University, July 1997

²⁷ Statement by the SEC upon release of Market 2000 Report.

The challenge is to incorporate new competitors into a regulatory structure that takes advantage of the benefits offered by technology while preserving the fundamental value of a strong centralised market.

In addition, regulators must establish general guidelines for all markets about fair and equitable practices. In considering how best to establish this new framework, several key issues must be addressed in the Canadian context.

4.2 Issues

4.2.1 Fragmentation

When trading in a particular security takes place in multiple locations rather than in a central marketplace, then fragmentation is said to have taken place. Fragmentation of a market can be either external or internal. External fragmentation occurs when alternative markets are established which compete with the primary market and take trading volume away from the central market. Internal fragmentation takes place when market participants find ways to match trades away from the central process.

The issue of fragmentation has been central to the discussion about an appropriate framework for ATs. When ATs first developed, there was strong opposition in Canada to allowing them to operate and great concern that the relatively small Canadian equity market would be severely damaged by fragmentation. However, in order to assess the impact of ATs, it is important to look at the causes of both internal and external fragmentation.

External fragmentation will occur when the same securities trade in different locations. However, prior concerns about the effects of fragmentation are largely unfounded in the context of a consolidated market. The negative effects of external fragmentation are mitigated when participants have access to information across markets and have the ability to access those markets. This is precisely the issue that the SEC dealt with over twenty years ago when they established the National Market System. In establishing the NMS, their objective was to provide for "equally regulated, individual markets linked together to make their best prices publicly known and accessible."²⁸ In its Market 2000 Report, the SEC observed that "dispersion of order flow among market centres has not impaired price discovery or market quality."²⁹

Internal fragmentation already exists in the Canadian equity market as a result of dealers internalising retail

order flows and trading in the "upstairs market". However the causes of internal fragmentation are rooted in the trading rules adopted by the exchanges themselves and can be addressed directly by the exchanges.³⁰

4.2.2 Competition

As discussed above, there is a belief among market participants that the regulators should not define or interfere with market structure. Regulators should establish an environment that allows for competition among markets, so that investors will have choices. Market theory suggests that allowing such competition will stimulate innovation and encourage markets to offer better features and services to their members and subscribers.

Because participants in traditional exchange markets have an incentive to resist technology and innovation that might decrease their intermediary power, regulators must allow competition so that innovators can develop and move forward. Observers of US markets, which have allowed competing ATs to operate for some time, have concluded that competition between markets has been beneficial; as noted by the SEC in its Market 2000 Report, "competition between market centres provides many benefits for the users of the markets."³¹

4.2.3 Consolidation

In the Market 2000 Report, the SEC put forth the view that the effects of fragmentation could be offset by appropriate consolidation of the markets. Consolidation of multiple markets is critical to preserving an effective price discovery mechanism across competing systems. Consolidation of the markets consists of two primary functions: data consolidation and market integration.

All participants in the markets must have full and complete access to information about the markets. Data consolidation will ensure that information about activity in all systems is available to any participant. This includes pre-trade information (the volume and price of bids and offers in each market) and post-trade information (the record of all trades that have taken place in all markets).

In addition, all participants must have equal access to the best price for execution across all markets. Market integration will ensure that participants who enter an

²⁸ SEC Release No. 34-40760, December 1998, Page 8.

²⁹ SEC Market 2000 Report

³⁰ TSE Special Committee Report on Market Fragmentation, Page.30

³¹ SEC Market 2000 Report

order into one system will have access to the best price available in any system at the time of execution.

The CSA believe that it is critical to provide for a Consolidated Canadian Market if ATs are allowed to operate in competition with traditional market structures.

4.2.4 Regulation of ATs

If ATs are to operate in an environment where they are not required to be members of an existing exchange, as they are now, and are allowed to operate markets that compete with exchanges, then they must also be regulated in some fashion. In today's markets, participants are subject to both member regulation and market regulation. Member regulation will typically include registration of participants, certification and oversight of sales activities. Market regulation will include several related functions: establishing rules regarding trading practice, surveillance and enforcement.

After considerable discussion on this topic, most observers believe that the time has come for a suitable framework to be developed which will include ATs within an appropriate regulatory framework but will not force them to be regulated by the very systems against which they compete. A recent study carried out for The Toronto Stock Exchange at the University of Toronto, concluded, "it will be hard for the Exchange to be seen simultaneously as an independent regulator of, and a vigorous competitor to, proprietary trading systems"³². However, it is also accepted that ATs must be subject to oversight and should not be allowed to operate in competition with the exchanges outside of the self-regulatory structure.

The matter of how the regulation of ATs should be carried out becomes critical. If ATs are to be somewhat independent of the exchanges, then another SRO must regulate them. In Canada, at this time, the IDA performs member regulation. However, the IDA does not perform market regulation and there is no body independent of the exchanges that performs market regulation. The CSA is of the view that that market regulation must be performed by an entity that has the knowledge and expertise to provide effective oversight and is recognized to perform that function by the securities regulators.

In the United States, ATs are able to register as dealers subject to oversight by NASD-R. NASD-R is the regulatory arm of the NASD and, while the same parent corporation that owns and operates the

NASDAQ stock market owns it, the regulatory arm is a separate entity that has its own board of governors and management team. Clearly, in Canada, it would be preferable to have an independent self-regulatory organization ("SRO") that could provide both member regulation and market regulation.

As stated previously, market regulation consists of three functions: establishing rules, surveillance and enforcement of those rules. If there is to be fair and consistent competition between alternative markets and traditional exchanges, then the regulators must establish framework rules. Until there is an alternative independent choice for regulation in Canada, surveillance and enforcement of the market regulatory framework will be carried out by the SRO's that have been recognized to perform that function. To deal with competitive issues, however, ATs will be permitted to choose the SRO that will perform their market regulation function. Allowing ATs the opportunity to choose also gives the exchanges an opportunity to compete based on services and to recapture some of the costs they incur as self-regulatory organizations.

4.3 Specific Issues in the Canadian Market

4.3.1 Concentration

A few large firms dominate the Canadian securities market. In particular, the five bank-owned full-service brokerages account for over 50% of trading volumes and the top 10 firms represent over 80% of trading volumes. This concentration raises concerns over the ability of a small number of firms to impact our capital markets. Specifically, in relation to alternative trading systems, market observers have expressed concerns about the effect on the market if one or more large dealers set up their own AT system for their customers and remove their order flow from the exchanges. In order to decrease the possibility of dealers finding this an attractive option, they have suggested that ATs be permitted to act as agents only and not be allowed to trade on a principal basis with their own customers.

4.3.2 Internal Fragmentation and Reduced Liquidity

For the most part, external fragmentation (as defined above) in Canada has been held off by the exchanges' insistence that alternative markets not be allowed to operate because they would cause fragmentation in our relatively small market.

Internal fragmentation, however, is a problem in our market. Internal fragmentation occurs when all orders are not committed to a central location so that they are not included in the price discovery process and buyers and sellers do not all have the opportunity to interact with all orders.

³² Professors Daniels, Trebilcock, Halpern and Macey, *The Toronto Stock Exchange and the Public Interest: A Paradigm in Transition*, University of Toronto, 1998, Page 135

Over the past ten years, the TSE has seen a decline in the relative percentage of orders entered into the electronic book and a gradual but steady increase in orders which are matched off-exchange and then "printed" on the exchange. Although these trades are included in the total volumes reported for the exchange, they do not contribute to the liquidity of the market. When the majority of orders are matched outside of the electronic book, this means that a relatively small number of orders are setting the bid/ask price level and being used for price determination for off-exchange order matches. The causes of this migration of orders away from the exchange are many, but they have been directly influenced by changes in TSE trading rules over the past 10 years. TSE rule changes have led directly to "upstairs trading" of block orders and to internalization of retail order flows and therefore internal fragmentation.

As institutional participation in the market has grown, institutions have found it increasingly difficult to match large blocks of stock. Institutions have also been concerned about showing the full size of their orders and suffering the negative effects of market impact when others are aware of their intentions to purchase or liquidate a large block. As a result, specialized institutional trading desks developed the practice in the 1980's of advertising their large orders ("shopping blocks") in order to put together large block crosses, thus earning the broker two commissions when he was able to put together a match. In addition, dealers were called upon frequently to use their own capital to supply liquidity for large trades. TSE rules have evolved over time to accommodate crosses³³ and customer-principal trades³⁴. Critics of the rules have said that TSE rules do not protect orders in the market and that they specifically encourage dealers to make deals off-exchange and to use the exchange merely to "print trades".³⁵

The lack of liquidity in the exchange book has been further impacted by the large retail houses internalising their order flow and acting as a principal on trades with their own customers. Changes to the TSE client principal trade rule in 1985 meant that dealers could buy from their customers at the bid and sell to them at the offer, thus taking the spread. This practice was further encouraged when the TSE implemented changes to accommodate Order Management

Systems, which then enabled member firms to manage their order flow and route orders away from the exchange to their trading desks. The SC Report on Fragmentation cited this as one of the principal causes of reduced order flow to the exchange and recommended changes to the client-principal trade rules.³⁶ The SC Report expressed concern that "internalization negatively impacts market quality" and that "in the long run, the continuous pursuit of parochial interests by member firms could act to the detriment of the TSE overall".³⁷

Section 5: Recent Developments

5.1 Demutualization

In October of 1998, The Toronto Stock Exchange published its "*Blueprint for Success*", outlining an analysis of the challenges and threats facing it as Canada's senior equities exchange. The paper outlined a new strategic direction for the TSE, recommending specifically that the exchange adopt a new ownership and governance structure. This new structure would see a restructuring of the member-owned TSE into a shareholder-owned, for-profit corporation, which would be governed by a Board of Directors, composed of increased representation from outside the investment dealer community.

On June 10, 1999, the Board and membership of the TSE voted to proceed with demutualization. This decision reflects the exchange's changing vision and its response to increasing competition from other markets, inside and outside of Canada. It is the view of the CSA that the implementation of a new corporate structure will not by itself change the nature of the TSE's operation. The TSE will continue to perform key functions that are intrinsic to operating as an exchange. As a result, the CSA believes that the TSE should continue to be regulated as an exchange and accept its public interest mandate.

5.2 Exchange Restructuring

In March 1999, The Toronto, Montreal, Alberta and Vancouver Exchanges signed a memorandum of Agreement to restructure exchange activities along lines of market specialization. Under terms of the agreement, the TSE would become the senior equities market in Canada, the ME would assume responsibility for the derivatives market, and the ASE and VSE would

³³ Prior to 1970, a put-through was required to give up 15% of the volume to orders on the bid or offer.

³⁴ In 1975, client-principal trades were only allowed over \$400,000. The rule was amended in 1977 to allow trades over \$100,000, subject to displacement and client priority. In 1984, the dollar amount restriction was removed as long as the client received price improvement; in 1985, client principal trades were allowed and only needed to equal the bid-offer.

³⁵ This criticism was noted in a survey of US institutions regarding trading practices in Canada in the TSE Special Committee Report on Fragmentation.

³⁶ The Report recommended that dealers be required to immediately enter orders of 1200 shares or less to the electronic book and that client-principal trades of 5000 or less only be allowed when the client received a price better than the existing bid/offer. These changes were adopted in 1998.

³⁷ TSE Report of the Special Committee on Fragmentation, Page 75.

merge to form a new Canadian junior market which would include junior issues listed on the ME and the Canadian Dealing Network ("CDN"). The intent of the restructuring by the exchanges was to allow each exchange to focus on core strengths, to minimize duplication of investments in infrastructure and services, to streamline activities for member firms and to allow the exchanges to compete more effectively in a rapidly changing environment.

If competition between exchanges is reduced, then investors will face fewer choices than they have today. It becomes even more important that ATSs be allowed to operate independently of exchanges and to offer competitive services and markets, to maintain investor choice.

Under the restructuring proposal, consolidation of markets, in fact, becomes easier since each ATS will only have to connect to the principal exchange for the securities it wishes to trade. Exchanges themselves will not have to connect to other exchange markets for order integration, as they would have for interlisted issues.

The more complex issue becomes that of regulatory oversight. Until there is an independent SRO who could perform market regulation in Canada, ATSs will have to contract with an existing exchange to perform that function. It clearly would be preferable for ATSs to have several alternatives in the choice of regulation. On the other hand, it is also important that the SRO chosen to perform regulation have the experience and knowledge to effectively perform that function. The exchanges have expressed the view that ATSs should be required to contact with the exchange where issues are listed. This would mean, for example, that an ATS trading junior issues would be required to contract with the new junior exchange rather than being able to choose either the TSE or the ME as an alternative. The question becomes more complex when one considers that an ATS may wish to trade a variety of issues. If an ATS were trading both junior and senior equities, would it be required to have market regulation performed by both the junior and senior equity exchanges or by only one? The key issue for regulators, in a restructured environment, is that ATSs must contract with an SRO who is recognized and qualified to perform the regulation function, but exchanges who are operating competing marketplaces must not be allowed to use their regulatory power to hinder fair competition.

The CSA is reviewing the implications of the exchange restructuring proposal for National Instrument Rule 21-101 and National Instrument 23-101 and will continue to amend the instruments and/or policies, as required, when further detailed plans are set forth by the exchanges and when the proposal has received all the member and regulatory approvals required.

Appendix “B” to Notice - Summary of Instruments

Appendix B

Summary of National Instrument 21-101

National Instrument 21-101 has 12 parts.

Part 1. Section 1.1 contains the definitions of terms and phrases used in the National Instrument that are not defined in or interpreted under a definition instrument in force in the jurisdiction. The terms "ATS", "ATS security", "marketplace" and "marketplace participant" are discussed in Part A of the Notice.

Part 2. Part 2 provides that the proposed Instrument does not apply to a marketplace that is a member of a recognized exchange in any jurisdiction. This is particularly relevant to an ATS, as one of the options available to an ATS is to operate as a member of a recognized exchange.

Part 3. Section 3.1 requires an applicant for recognition as an exchange to file Form 21-101F1. Section 3.2 requires an applicant for recognition as an exchange and a recognized exchange to file an amendment to Form 21-101F1 within the time period specified in that section upon the occurrence of a change in the information on that form or an amendment to that form.

Part 4. Section 4.1 requires an applicant for recognition as a quotation and trade reporting system to file Form 21-101F1. Section 4.2 requires an applicant for recognition as a quotation and trade reporting system or a recognized quotation and trade reporting system to file an amendment to Form 21-101F1 within the time period specified in that section upon the occurrence of a change in the information on that form or an amendment to that form.

Part 5. Part 5 contains requirements applicable only to recognized exchanges and recognized quotation and trade reporting systems. Section 5.1 requires a recognized exchange and recognized quotation and trade reporting system to establish written standards for granting access to trading, to not unreasonably prohibit or limit access to services offered by it and to keep records of grants of access and denials or limitations of access. Section 5.2 provides that a recognized exchange or recognized quotation and trade reporting system shall not prohibit, condition, or otherwise limit, directly or indirectly, a member or user from effecting a transaction on an ATS. Section 5.3 requires a recognized exchange and recognized quotation and trade reporting system to adopt regulatory instruments that are not contrary to the public interest and are designed to accomplish certain objectives, including ensuring compliance with securities legislation, preventing fraud, promoting just and equitable principles of trade and fostering cooperation and coordination with persons or companies facilitating transactions in securities. Section 5.3 also requires a recognized exchange and recognized quotation and trade reporting system not to permit unreasonable discrimination between customers, issuers and members or users, and not to impose any burden on competition not necessary or appropriate in furtherance of securities legislation. Section 5.4 requires a recognized exchange and recognized quotation and trade reporting

system to have regulatory instruments that provide that members and users shall be appropriately disciplined for violations of securities legislation and the regulatory instruments of the exchange or quotation and trade reporting system. Section 5.5 requires a recognized exchange and recognized quotation and trade reporting system to file with each securities regulatory authority that recognized it all regulatory instruments, and amendments to those instruments adopted by the exchange or quotation and trade reporting system. Section 5.6 requires a recognized exchange and recognized quotation and trade reporting system to prepare and file annual audited financial statements. The statements must be prepared in accordance with Canadian GAAP or, in the case of an entity incorporated in a foreign jurisdiction, reconciled with Canadian GAAP.

Part 6. Part 6 contains requirements applicable only to ATSS. Section 6.1 provides that an ATS shall not carry on business unless it is registered as a dealer and it is a member of a self-regulatory entity. Currently the Investment Dealers Association of Canada is the only entity that meets the criteria of self-regulatory entity. Section 6.2 sets out the reporting requirements of an ATS, including the requirement to file an initial operation report, an amendment to that report, and a report on operations. Section 6.3 sets out the filings that an ATS is required to make when it wishes to cease carrying on business. Section 6.4 requires an ATS to give the securities regulatory authority six months notice before it begins to carry out certain activities such as listing securities, guaranteeing liquidity, adopting requirements governing the conduct of subscribers or establishing procedures for disciplining subscribers. These would all be activities that would take a person or company outside of the definition of ATS and would result in the securities regulatory authorities considering the person or company to be an exchange for purposes of securities legislation. Section 6.5 requires an ATS to provide notice to the securities regulatory authority if, during at least three of the preceding four calendar quarters, (i) trades on the ATS in any type of ATS security are equal to or greater than 40 percent of the average daily dollar value of the trading volume in that type of security on all marketplaces on which the type of ATS security trades, or (ii) trades on the ATS in a specific ATS security are equal to or greater than 50 percent of the average daily dollar value of the trading volume in that security on all marketplaces on which the ATS security trades and in any type of ATS security are equal to or greater than five percent of the average daily dollar value of the trading volume in that type of security on all marketplaces on which the type of ATS security trade. Section 6.6 prohibits a securityholder of an ATS and an affiliated entity of that securityholder from buying or selling securities on the ATS for their own account. Section 6.7 prohibits an ATS from releasing a subscriber's trading information to a person or company other than the subscriber and requires an ATS to implement reasonable safeguards and procedures to protect a subscriber's trading information. Section 6.8 prohibits an ATS from using in its name the word "exchange", the words "stock market", or any derivations of those terms.

Part 7. Part 7 of the proposed Instrument contains information transparency requirements for marketplaces. Section 7.1 requires a marketplace that displays orders to a person or company, other than its own employees or agents

retained by it to assist in the operation of the marketplace, to provide to the data consolidator information regarding the total disclosed volume at each of the five best bid price and ask price levels for each security traded on the marketplace. Section 7.2 requires a marketplace to provide to the data consolidator accurate and timely information regarding details of all trades executed on the marketplace. Section 7.3 requires the data consolidator to produce a consolidated feed showing the information provided to the data consolidator under section 7.1 and 7.2 and the identity of the marketplace on which each trade takes place.

Part 8. Part 8 contains the market integration provisions of the proposed Instrument. Subsection 8.1(1) requires a marketplace that displays orders to a person or company to comply with the requirements of the market integrator to provide for access to orders displayed through the data consolidator. Subsection 8.1(2) requires a marketplace when receiving an order from another marketplace to apply its own rules to the execution of that order. Subsection 8.1(3) requires a marketplace to provide to marketplace participants of any other marketplace access to the orders it displays to the data consolidator that is equivalent to the access that the marketplace provides to its own marketplace participants.

Part 9. Section 9.1 requires a marketplace that charges a transaction fee that is greater than \$0.005 per security purchased or sold to disclose that transaction fee in the ask price or bid price displayed by it.

Part 10. Part 10 contains the recordkeeping requirements for marketplaces. Section 10.1 requires a marketplace to keep such records as are necessary for the proper recording of its business. Section 10.2 also requires a marketplace to keep other records, including a record of all marketplace participants who have been granted access to trading in the marketplace and daily trading summaries for the marketplace. Section 10.3 requires a marketplace to keep for not less than seven years, the first two years in a readily accessible location, all records required to be made by it under sections 10.1 and 10.2, at least one copy of its standards for granting access to trading and records relevant to its decision to grant, deny or limit access, records made or received by it in the course of complying with the system's requirements set out in section 11.1 and all written notices provided by the marketplace to marketplace participants generally. Subsection 10.3(2) also requires a marketplace to keep all organizational documents, copies of all forms filed under the Instrument and notices provided under the Instrument. Section 10.4 allows a marketplace to, generally, keep all records, documents and forms referred to in Part 10 by means of mechanical, electronic or other devices.

Part 11. Section 11.1 applies to a marketplace's systems that support order entry, order routing, execution, trade reporting and trade comparison. Section 11.1 requires an ATS subject to section 11.1, a recognized exchange and a recognized quotation and trade reporting system to make capacity estimates, conduct capacity stress tests of critical systems, develop certain procedures to review and keep current the development and testing methodology, and establish reasonable contingency and business continuity plans. All these requirements are necessary in order for

marketplaces to process transactions in an accurate, timely and efficient manner and ensure that systems can continue to operate in the event of the occurrence of physical hazards or natural disasters. Section 11.1 also requires the marketplaces subject to that section to notify the securities regulatory authority of material systems failures and changes and, on an annual basis, perform an independent review of their controls for ensuring compliance with section 11.1. Section 11.1 only applies to an ATS if trades on the ATS in any type of ATS security during four of any six consecutive calendar months are greater than 20 percent of the average daily dollar value of the trading volume in that type of security on all marketplaces on which the type of ATS security trades.

Part 12. Section 12.1 provides for the granting of exemptions from the Instrument.

Summary of Companion Policy 21-101CP

Companion Policy 21-101CP has 13 parts.

Part 1. Section 1.1 sets out the purpose of the Companion Policy, being to state the views of the Canadian securities regulatory authorities on various matters related to the proposed Instrument.

Part 2. Section 2.1 discusses the characteristics of a "marketplace", as defined in the proposed Instrument. Subsections 2.1(3) and (4) set out the views of the CSA on what it means to "bring together orders for securities and "to use established, non-discretionary methods under which the orders interact with each other". Subsection 2.1(5) describes systems that the CSA do not consider to be marketplaces for purposes of the Instrument.

Part 3. Part 3 contains a discussion of the characteristics of exchanges, quotation and trade reporting systems and ATSs. Subsections 3.1(2) and (3) discuss the characteristics that the CSA generally associate with an exchange. Subsection 3.1(6) contains an explanation as to why the CSA want an ATS to inform it when it reaches or exceeds the 40 percent volume threshold referred to in subsection 6.5(1) of the proposed Instrument. Subsection 3.1(7) provides guidance by the CSA as to what is meant by "type" of security as used in the volume threshold tests in the proposed Instrument. Section 3.2 sets out the definition of quotation and trade reporting system commonly found in securities legislation and provides that a person or company that carries on business as a vendor of market data would not normally be considered to be a quotation and trade reporting system. Subsection 3.1(2) provides that a person or company cannot carry on business as a quotation and trade reporting system unless it is recognized appropriately in the local jurisdiction or it is an ATS that is in compliance with the proposed Instrument. Section 3.3 provides certain guidance as to the operation of an ATS. Subsection 3.3(1) provides that a marketplace that requires listing agreements, has market makers or sets rules governing the conduct of subscribers or disciplines subscribers would be an exchange and would have to be recognized as such in order to carry on business. Subsection 3.3(2) provides that the CSA do not consider an ATS that is in compliance with subsection 7.1(3)

of the proposed Trading Rules to be disciplining subscribers. Subsection 3.3(3) provides that a marketplace that would otherwise meet the definition of an ATS in the proposed Instrument may apply to the CSA for recognition as an exchange. Subsection 3.3(7) provides that at this time, the Investment Dealers Association of Canada is the only body that would come within the definition of self-regulatory entity for purposes of the proposed Instrument. Subsection 3.3(8) clarifies that section 6.6 of the proposed Instrument, which prohibits a securityholder of an ATS and an affiliated entity of that securityholder from buying or selling securities on that ATS for their own account, does not prevent those persons or companies from trading on another marketplace either as agent or principal.

Part 4. Section 4.1 provides that in selecting the data consolidator and market integrator for purposes of the proposed Instrument, the members of the CSA will act together.

Part 5. Subsection 5.1(2) provides that in exercising their public interest power in deciding whether to recognize an exchange or quotation and trade reporting system, the Canadian securities regulatory authorities will look at a number of factors, including the manner in which the exchange or quotation and trade reporting system proposes to comply with the proposed Instrument, whether the exchange or quotation and trade reporting system has fair and meaningful representation on its governing body, whether the exchange or quotation and trade reporting system has sufficient financial resources for the proper performance of its functions and whether the regulatory instruments adopted by the exchange or quotation and trade reporting system ensure that its business is conducted in an orderly manner so as to afford protection to investors.

Part 6. Section 6.2 sets out the views of the CSA on the term "order" that is defined in section 1.1 of the proposed Instrument. It provides that the label put on a transaction is not determinative of whether the transaction constitutes an order, but instead what is determinative is what actually takes place between the buyer and seller.

Part 7. Section 7.1 provides guidance as to the forms filed by marketplaces. Subsection 7.1(1) provides that a marketplace must apply to the CSA if it wishes to keep the forms filed confidential. Subsection 7.1(2) provides guidance as to the proposed term "significant" in subsection 6.2(2) of the proposed Instrument and indicates that in the view of the CSA, a change to the operations of an ATS is significant if it includes any changes to the operating platform of an ATS, the types of securities traded or the types of subscribers. Subsection 7.1(4) explains that subsection 6.3(1) of the proposed Instrument applies to an ATS that voluntarily ceases to carry on business and subsection 6.3(2) applies to an ATS that involuntarily ceases to carry on business.

Part 8. Part 8 elaborates on requirements in Part 5 of the proposed Instrument that are only applicable to exchanges and quotation and trade reporting systems. Section 8.1 makes it clear that the access requirements in section 5.1 of the proposed Instrument do not restrict the authority of an exchange or quotation and trade reporting system to maintain

reasonable standards for access. Section 8.2 makes it clear that section 5.4 of the proposed Instrument does not preclude enforcement action by any other person or company, including the Canadian securities regulatory authorities. Section 8.3 provides that the securities regulatory authority will determine which of the regulatory instruments filed by a recognized exchange and recognized quotation and trade reporting system it will review based on securities legislation and other factors.

Part 9. Section 9.1 provides guidance as to section 6.7 of the proposed Instrument. That section requires an ATS not to carry on business unless it has implemented reasonable safeguards and procedures to protect a subscriber's trading information. Section 9.1 sets out the CSA's views on what should be included within those safeguards and procedures.

Part 10. Section 10.1 indicates that the reference to "total disclosed volume" in subsection 7.1(1) of the proposed Instrument refers to the amount of orders that is displayed in the marketplace. Volumes that are not disclosed or that are "reserve" or hidden volumes are not required to be displayed. Subsection 10.1(2) makes it clear that the CSA expect that information required to be provided to the data consolidator under the proposed Instrument will be provided in real time or as close to real time as possible.

Part 11. Section 11.1 provides guidance as to the operation of subsection 8.1(2) of the proposed Instrument. That subsection requires a marketplace, when receiving an order from another marketplace, to apply its own rules to the execution of that order. Section 11.1 explains that subsection 8.1(2) of the proposed Instrument requires a marketplace that displays orders through the data consolidator to provide access to its passive booked orders. Section 11.2 provides that subsection 8.1(3) of the proposed Instrument requires a marketplace to be able to receive from or send orders to another marketplace to which it is linked. Subsection 11.1(2) provides examples of practices that the CSA would consider to be in breach of subsection 8.1(3) of the proposed Instrument.

Part 12. Section 12.1 makes it clear that the CSA can require a marketplace to deliver to them any of the records required to be kept by the marketplace under securities legislation, including the records required to be maintained under Part 10 of the proposed Instrument.

Part 13. Section 13.1 provides guidance as to the capacity, integrity and security system's requirements of section 11.1 of the proposed Instrument. Subsection 13.1(2) provides that the activities described in section 11.1 of the proposed Instrument must be carried out at least once a year and the CSA would require these activities to be carried out even more frequently if there is a change to the marketplace that is material either in terms of structure or volume of trading that necessitates more frequent review. Subsection 13.1(3) makes it clear that the independent review should be performed by competent, independent audit personnel following established audit procedures and standards. Subsection 13.1(4) clarifies that once an ATS becomes subject to section 11.1 of the proposed Instrument, it remains subject to that section even if thereafter, it no longer satisfies

the volume tests in section 11.2 of the proposed Instrument unless it is successful in obtaining relief under the proposed Instrument.

Summary of Forms

The CSA are adopting four forms with the proposed Instrument. Form 21-101F1 is a form required to be filed by an exchange and quotation and trade reporting system when applying for recognition as an exchange and quotation and trade reporting system. The form contains a number of exhibits relating to the exchange and quotation and trade reporting system and affiliated entities.

Form 21-101F2 is the form required to be filed by an ATS when beginning operations or when changes occur to the information on that form. It also contains certain exhibits that include information as to the classes of subscribers on the ATS, a list of the types of securities that the ATS trades or expects to trade, other persons involved in the operation of the ATS and certain information as to the manner of operation of the ATS, procedures governing entry of orders into the ATS, means of access to the ATS, and fees charged by the ATS.

Form 21-101F3 is the form that must be filed by an ATS within 30 days after the end of each calendar quarter in which it operates. That form contains information as to ATS securities traded by the ATS during that calendar quarter, including type of securities and dollar volume.

Form 21-101F4 is the form required to be filed by an ATS when it ceases operations. The ATS must indicate why the ATS is ceasing operations and whether it holds securities or monies for any subscribers and arrangements made to return those securities or monies.

Summary of Trading Rules

The proposed Trading Rules Instrument has nine parts.

Part 1. Section 1.1 contains the definitions of terms and phrases used in the National Instrument that are not defined in or interpreted under a definition instrument in force in the jurisdiction.

Part 2. Part 2 contains provisions designed to prevent manipulation or fraud. Subsection 2.1(1) prohibits a person or company from engaging in or participating in a transaction or series of transactions or method of trading relating to a trade in or acquisition of a security if the person or company knows, or ought reasonably to know, that the transaction or series of transactions or method of trading results in or contributes to a misleading appearance of trading activity in, or an artificial price for, a security or perpetrates a fraud on any person or company. In Alberta, British Columbia and Quebec, provisions of securities legislation relating to manipulation and fraud apply instead of subsection (1). Section 2.2 prohibits a person or company from engaging in or participating in any transaction or series of transactions or method of trading relating to a trade in or acquisition of a security in an attempt to create a misleading appearance of

trading activity in or an artificial price for a security or perpetrate a fraud on any person or company. Subsection 2.3(1) prohibits a person or company that has sold a put option from placing an offer to purchase securities of the same class of securities as those underlying the option at a price higher than the last price at which the underlying security last traded, while the option remains unexercised. Subsection 2.3(2) contains a similar prohibition for a call option.

Part 3. Subsection 3.1(1) prohibits a short sale of a security through the facilities of a marketplace (a) below the price of which the last sale of a board lot was displayed by the market consolidator or, (b) at the price at which the last sale of board lot was displayed by the market consolidator unless the last sale price was higher than the previous sale price of a board lot. Subsection 3.1(2) contains certain exceptions to the prohibition in subsection 3.1(1).

Part 4. Subsection 4.1(1) prohibits a marketplace participant either as principal or agent, from front running, *ie.*, purchasing or selling securities of a particular class or a derivative of those securities on a marketplace with knowledge of an order for the purchase or sale of those securities or the potential purchase or sale of those securities, if that information has not been generally disclosed. Subsection 4.1(2) prohibits a marketplace participant from informing, other in the necessary course of business, another person or company of an order for the purchase or sale of securities or the potential purchase or sale of securities on a marketplace if that information has not been generally disclosed. Subsection 4.1(3) prohibits a marketplace participant from purchasing or selling securities of an issuer or derivative of those securities in advance of the general disclosure of a report prepared by a person or company relating to those securities or the issuer of those securities if the marketplace participant has knowledge of the report and the report can reasonably be expected to have an impact on the price of the security. A marketplace participant may not disclose, other than in the necessary course of business, the forthcoming disclosure of such a report. Section 4.2 prohibits trading on inside information with respect to an issuer whose securities trade on a marketplace in Canada, where the issuer is not incorporated under the laws of Canada or a jurisdiction and is not a reporting issuer. Section 4.2 also prohibits tipping with respect to a material fact or material change with respect to that issuer. Section 4.3 contains defences to the prohibitions in sections 4.1 and 4.2.

Part 5. Part 5 contains best execution rules. Subsection 5.1(1) requires a marketplace participant acting as agent for a customer to make reasonable efforts to ensure that the customer receives the best execution price on a purchase or sale of securities by the customer. Subsection 5.1(2) requires a marketplace participant acting as agent for a customer to not execute a transaction on a marketplace that could be filled at a better price on another marketplace displayed in the consolidated market display. Subsection 5.1(3) requires a marketplace participant to make reasonable efforts to use facilities providing information or ability to execute orders in order to satisfy subsection 5.1(1).

Part 6. Subsection 6.1(1) provides that a marketplace participant, whether acting as agent or principal, having

offsetting orders to buy and sell the same security at the same price shall not execute the trade for any quantity at a price equal to the best bid or best offer displayed in the consolidated market display unless the marketplace participant first satisfies any bids or offers displayed in the consolidated market display at or better than the execution price. Subsection 6.1(2) provides that a marketplace participant that receives an order to buy or sell 10,000 shares or less of a security traded on a marketplace may not execute a principal transaction for those securities unless the marketplace participant buys at a higher price or sells at a lower price than the best bid or best offer displayed in the consolidated market display.

Part 7. Subsection 7.1(1) requires a recognized exchange and recognized quotation and trade reporting system to set requirements that prohibit marketplace participants from engaging in any of the conduct prohibited under the proposed Trading Rules and requiring marketplace participants to act in accordance with the best execution rules in Part 5. Subsection 7.1(2) requires a recognized exchange and recognized quotation and trade reporting system to monitor and enforce compliance with proposed Trading Rules either directly if it has been approved to do so by the securities regulatory authority or through an approved agent. Subsection 7.1(3) requires an ATS to enter into an agreement with an approved agent to monitor and enforce compliance with the requirements of the proposed Trading Rules.

Part 8. Section 8.1 provides for the granting of an exemption from the proposed Trading Rules.

Summary of Proposed Companion Policy 23-101CP

Proposed Companion Policy 23-101CP contains seven parts.

Part 1. Section 1.1 provides that the purpose of the proposed Companion Policy is to state the views of the CSA on various matters related to the proposed Trading Rules. Section 1.2 provides that as a general matter the Canadian securities regulatory authorities expect marketplace participants to transact business openly and fairly, and in accordance with just and equitable principles of trade.

Part 2. Subsection 2.1(1) indicates that subsection 2.1(1) of the proposed Trading Rules prohibits price manipulation and deceptive trading as this is detrimental to investors and the integrity of the markets. It explains generally what is meant by price manipulation and deceptive trading. Subsection 2.1(4) sets out instances where the Canadian securities regulatory authorities would consider activities of a person or company to result in or contribute to a misleading appearance of trading activity in or an artificial price for a security. Subsection 2.1(5) indicates that normal market stabilization activities would not be considered to be a breach of subsections 2.1(1) and (2) of the proposed Trading Rules. Subsection 2.1(7) provides that subsections 2.1(3) and (4) of the proposed Trading Rules refers to "capping and pegging".

Part 3. Subsection 3.1(1) indicates that subsection 3.1(1) of the proposed Trading Rules refers to what is known as a "zero-plus tick" rule.

Part 4. Subsection 4.1(1) indicates that subsection 4.1(1) of the proposed Trading Rules prohibit "front running". Subsection 4.1(2) indicates that subsection 4.1(2) of the proposed Trading Rules prohibit tipping. Subsection 4.1(3) indicates that section 4.2 of the proposed Trading Rules, which prohibits insider trading with respect to issuers whose securities trade on a marketplace in Canada if the issuer is incorporated outside of Canada or a jurisdiction, is necessary because an ATS may trade foreign securities. Subsection 4.1(4) elaborates on the "Chinese Wall" defence in section 4.3 of the proposed Trading Rules.

Part 5. Subsection 5.1(1) provides guidance as to the requirements in subsection 5.1(1) of the proposed Trading Rules to make reasonable efforts to ensure that the customer receives the best execution price. Subsection 5.1(1) provides that in making reasonable efforts, a marketplace participant should consider whether it would be appropriate in particular circumstances to look at markets outside of Canada. Subsection 5.1(2) explains the rationale of the trade-through provisions in subsection 5.1(2) of the proposed Trading Rules. Subsection 5.1(3) sets out the views of the Canadian securities regulatory authorities on price improvement.

Part 6. Subsection 6.1(1) provides that a cross, as described in subsection 6.1(1) of the proposed Trading Rules is considered to be an offsetting order to buy and sell entered by a marketplace participant as principal or agent in any marketplace. Subsection 6.1(2) sets out the views of the Canadian securities regulatory authorities as to principal transactions.

Part 7. Section 7.1 provides that for the purposes of subsection 7.1(2) of the proposed Trading Rules, at this time, all exchanges in Canada have been approved for monitoring and enforcement compliance purposes.

National Instrument 21-101 - Marketplace Operations

**NATIONAL INSTRUMENT 21-101
MARKETPLACE OPERATION**

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APPENDIX A

**NATIONAL INSTRUMENT 21-101
MARKETPLACE OPERATION**

PART 1 DEFINITIONS AND INTERPRETATION

1.1 Definitions¹ - In this Instrument

"alternative trading system" means a marketplace that

- (a) brings together purchasers and sellers of ATS securities only,
- (b) is not a recognized quotation and trade reporting system or a recognized exchange, and
- (c) does not
 - (i) require an issuer to enter into an agreement to have its securities traded on the marketplace,
 - (ii) provide, directly, or through one or more subscribers, a guaranteed minimum size order for any securities traded on the marketplace for the purposes of ensuring liquidity for those securities,
 - (iii) set requirements governing the conduct of subscribers, other than conduct in respect of the trading by those subscribers on the marketplace, or
 - (iv) discipline subscribers other than by exclusion from participation in the marketplace;

"ask price" means the price of an order to sell at least one board lot;

"ATS" means an alternative trading system;

"ATS security" means

- (a) a security issued by a person or company that is a reporting issuer in any jurisdiction,²
- (b) a derivative of a security³ described in paragraph (a),
- (c) a debt security of or guaranteed by the government of Canada or a jurisdiction, or
- (d) a security listed or quoted on a market set out in Appendix A or any successor to that market;

"bid price" means the price of an order to buy at least one board lot;

"board lot" means, in the case of a recognized exchange, recognized quotation and trade reporting system or ATS, the standard trading unit in which a particular security is traded on the exchange, quotation and trade reporting system or ATS;

"data consolidator" means the person or company selected by the securities regulatory authority to receive information from a marketplace in accordance with Part 7;

"market integrator" means the person or company selected by the securities regulatory authority to provide access to orders in accordance with Part 8;

"marketplace" means

- (a) an exchange,
- (b) a quotation and trade reporting system, and
- (c) any other person or company that
 - (i) constitutes, maintains or provides a market or facilities for bringing together purchasers and sellers of securities,
 - (ii) brings together the orders for securities of multiple buyers and sellers, and
 - (iii) uses established, non-discretionary methods under which the orders interact with each other, and the buyers and sellers entering the orders agree to the terms of a trade;

¹ A national definition instrument has been adopted as National Instrument 14-101 Definitions. It contains definitions of certain terms used in more than one national instrument. National Instrument 14-101 also provides that a term used in a national instrument and defined in the statute relating to securities of the applicable jurisdiction, the definition of which is not restricted to a specific portion of the statute, will have the meaning in that jurisdiction given to it in that statute, unless the context otherwise requires. National Instrument 14-101 also provides that a provision or a reference within a provision in a national instrument that specifically refers by name to one or more jurisdictions, other than the local jurisdiction, shall not have any effect in the local jurisdiction, unless otherwise stated in the National Instrument.

² The term "jurisdiction" means a province or territory of Canada except when used in the term foreign jurisdiction.

³ The reference to a derivative of a security covers securities such as options and calls and puts, as these are not issued by the issuer of the securities.

"marketplace participant" means a member of an exchange, a user of a quotation and trade reporting system, or a subscriber of an ATS;

"member" means, for a recognized exchange,

- (a) a person or company holding at least one seat on the exchange, or
- (b) a registrant that has been granted direct trading access rights by the exchange and is subject to regulatory oversight by the exchange;⁴

"order" means a firm indication by a person or company, acting as either principal or agent, of a willingness to buy or sell a security;

"recognized exchange" means

- (a) a recognized stock exchange in Ontario,
- (b) a recognized exchange in Alberta, and
- (c) in every other jurisdiction, an exchange recognized by the securities regulatory authority under securities legislation to carry on business as an exchange;

"recognized quotation and trade reporting system" means

- (a) in every jurisdiction other than British Columbia, a quotation and trade reporting system recognized by the securities regulatory authority under securities legislation to carry on business as a quotation and trade reporting system, and
- (b) in British Columbia, a quotation and trade reporting system recognized by the securities regulatory authority under securities legislation to carry on business as a quotation and trade reporting system or as an exchange;

"self-regulatory entity" means a self-regulatory body or self-regulatory organization that

- (a) is not an exchange,
- (b) carries out member regulation, and
- (c) is recognized as a self-regulatory body or self-regulatory organization by the securities regulatory authority under securities legislation;

"subscriber" means, for an ATS, a person or company that has entered into a contractual

agreement with the ATS to access the ATS for the purpose of effecting trades in ATS securities, or submitting, disseminating, or displaying orders on the ATS for ATS securities;

"transaction fee" means the fee that a marketplace charges for execution of a trade; and

"user" means, for a recognized quotation and trade reporting system, a person or company that reports trades on the recognized quotation and trade reporting system.

1.2 Interpretation - Marketplace - For the purposes of the definition of marketplace in section 1.1, a person or company is not considered to constitute, maintain or provide a market or facilities for bringing together purchasers and sellers of securities, solely because the person or company routes orders to a marketplace or a dealer for execution.

1.3 Interpretation - Affiliated Entity

(1) In this Instrument, a person or company is considered to be an affiliated entity of another person or company if one is a subsidiary entity of the other or if both are subsidiary entities of the same person or company, or if each of them is controlled by the same person or company.

(2) In this Instrument, a person or company is considered to be controlled by a person or company if

- (a) in the case of a person or company,
 - (i) voting securities of the first-mentioned person or company carrying more than 50 percent of the votes for the election of directors are held, otherwise than by way of security only, by or for the benefit of the other person or company, and
 - (ii) the votes carried by the securities are entitled, if exercised, to elect a majority of the directors of the first-mentioned person or company;

(b) in the case of a partnership that does not have directors, other than a limited partnership, the second-mentioned person or company holds more than 50 percent of the interests in the partnership; or

(c) in the case of a limited partnership, the general partner is the second-mentioned person or company.

(3) In this Instrument, a person or company is considered to be a subsidiary entity of another person or company if

⁴ Paragraph (a) of the definition deals with the current structure of an exchange. Paragraph (b) contemplates the possible structure in certain jurisdictions after demutualization.

- (a) it is controlled by,
 - (i) that other,
 - (ii) that other and one or more persons or companies each of which is controlled by that other, or
 - (iii) two or more persons or companies, each of which is controlled by that other; or
- (b) it is a subsidiary entity of a person or company that is the other's subsidiary entity.

PART 2 APPLICATION

- 2.1 Application** - This Instrument does not apply to a marketplace that is a member of a recognized exchange in any jurisdiction.

PART 3 EXCHANGE-RECOGNITION

- 3.1 Application for Recognition** - An applicant for recognition as an exchange under securities legislation shall file Form 21-101F1.

3.2 Change in Information

- (1) An applicant for recognition as an exchange shall inform in writing the securities regulatory authority immediately of any change in the information on that form or on an amendment to that form, and the applicant shall file an amendment to Form 21-101F1 no later than seven days after a change in the information on that form or on an amendment to that form takes place.
- (2) A recognized exchange shall file an amendment to Form 21-101F1 no later than seven days after a change in the information on that form or an amendment to that form takes place.
- (3) The amendment to Form 21-101F1 referred to in subsections (1) and (2) shall set out any change in the information filed on that form or on an amendment to that form.

PART 4 QUOTATION AND REPORTING SYSTEM - RECOGNITION

- 4.1 Application for Recognition** - An applicant for recognition as a quotation and trade reporting system under securities legislation shall file Form 21-101F1.

4.2 Change in Information

- (1) An applicant for recognition as a quotation and trade reporting system shall inform in writing the securities regulatory authority immediately of any change in the information on that form or on an amendment to that form, and the applicant shall file an amendment to Form 21-101F1 no later than seven days after a change in the information on that form or on an amendment to that form takes place.
- (2) A recognized quotation and trade reporting system shall file an amendment to Form 21-101F1 no later than seven days after a change in the information on that form or an amendment to that form takes place.
- (3) The amendment to Form 21-101F1 referred to in subsections (1) and (2) shall set out any change in the information filed on that form or on an amendment to that form.

PART 5 REQUIREMENTS APPLICABLE ONLY TO RECOGNIZED EXCHANGES AND RECOGNIZED QUOTATION AND TRADE REPORTING SYSTEMS

- 5.1 Access Requirements** - A recognized exchange and a recognized quotation and trade reporting system shall

- (a) establish written standards for granting access to trading on it;
- (b) not unreasonably prohibit or limit access by a person or company to services offered by it; and
- (c) keep records of
 - (i) each grant of access including, for each member in the case of an exchange and for each user in the case of a quotation and trade reporting system, the reasons for granting such access, and
 - (ii) each denial or limitation of access, including the reasons for denying or limiting access to any applicant.

- 5.2 Trading Off Exchange or Quotation and Trade Reporting System** - A recognized exchange or recognized quotation and trade reporting system shall not prohibit, condition, or otherwise limit, directly or indirectly, a member or user from effecting a transaction on an ATS.

- 5.3 Public Interest Rules**

- (1) A recognized exchange and a recognized quotation and trade reporting system shall establish by-laws, rules, regulations, policies, procedures and practices and other similar instruments that
- (a) are not contrary to the public interest; and
 - (b) are designed, with respect to members in the case of an exchange and users in the case of a quotation and trade reporting system, to
 - (i) ensure compliance with securities legislation,
 - (ii) prevent fraudulent and manipulative acts and practices,
 - (iii) promote just and equitable principles of trade, and
 - (iv) foster cooperation and coordination with persons or companies engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in, securities.
- (2) A recognized exchange and a recognized quotation and trade reporting system shall not
- (a) permit unreasonable discrimination between customers, issuers and members in the case of an exchange, and between customers, issuers and users in the case of a quotation and trade reporting system; or
 - (b) impose any burden on competition that is not necessary or appropriate in furtherance of securities legislation.

5.4 Discipline Rules - A recognized exchange and a recognized quotation and trade reporting system shall have by-laws, rules, regulations or other similar instruments that provide that their respective members and users shall be appropriately disciplined for violations of securities legislation and the by-laws, rules, regulations, policies, procedures, practices and other similar instruments of the exchange or quotation and trade reporting system.

5.5 By-law Filing - A recognized exchange and a recognized quotation and trade reporting system shall file with the securities regulatory authority, if the securities regulatory authority has recognized it, all by-laws, rules, regulations, policies, procedures, practices, interpretations and other similar instruments, and all amendments thereto, adopted by the exchange or quotation and trade reporting system.

5.6 Filing of Annual Financial Statements

- (1) A recognized exchange and a recognized quotation and trade reporting system shall prepare annual audited financial statements, in accordance with, or in the case of a recognized exchange or recognized quotation and trade reporting system incorporated otherwise than under the laws of Canada or a jurisdiction, reconciled with, Canadian GAAP and covered by a report prepared by an independent auditor.
- (2) A recognized exchange and a recognized quotation and trade reporting system shall file with the securities regulatory authority the statements referred to in subsection (1) within 90 days after the end of its latest financial year, if it has filed a Form 21-101F1 with the securities regulatory authority.

PART 6 REQUIREMENTS APPLICABLE ONLY TO ATSS

6.1 Registration - An ATS shall not carry on business unless

- (a) it is registered as a dealer; and
- (b) it is a member of a self-regulatory entity.

6.2 Reporting Requirements

- (1) An ATS shall file an initial operation report on Form 21-101F2 at least 30 days before the ATS begins to carry on business as an ATS.
- (2) An ATS shall file an amendment to Form 21-101F2 at least 30 days before implementing a change to its operations that is significant.
- (3) If a change in the information on Form 21-101F2 or an amendment to that Form takes place, other than a change referred to in subsection (2), an ATS shall file an amendment to Form 21-101F2 no later than 30 days after the end of the calendar quarter in which the change takes place.
- (4) An ATS shall file Form 21-101F3 within 30 days after the end of each calendar quarter during any part of which the ATS has carried on business.

6.3 Ceasing to Carry on Business as an ATS

- (1) An ATS that intends to cease carrying on business shall file a report on Form 21-101F4 at least 30 days before ceasing to carry on business.
- (2) An ATS that involuntarily ceases to carry on business shall file a report on Form 21-101F4 as soon as practicable after it ceases to carry on business.

6.4 Notification of Non-ATS Activities

- (1) An ATS shall notify the securities regulatory authority in writing at least six months before it first
 - (a) requires an issuer to enter into an agreement before the issuer's securities can trade on the ATS;
 - (b) provides, directly, or through one or more subscribers, a guaranteed minimum size order for any ATS securities for the purposes of ensuring liquidity for those securities;
 - (c) sets requirements governing the conduct of subscribers, other than conduct in respect of the trading by those subscribers on the alternative trading system; or
 - (d) establishes procedures for disciplining subscribers other than by exclusion from trading.

6.5 Notification of Volume Thresholds

- (1) An ATS shall notify the securities regulatory authority in writing, if, during at least three of the preceding four calendar quarters,
 - (a) trades on the ATS in any type of ATS security are equal to or greater than 40 percent of the average daily dollar value of the trading volume in that type of security
 - (i) on all marketplaces in Canada, if the type of ATS security is traded only in Canada, and
 - (ii) on all marketplaces inside and outside of Canada, if the type of ATS security is traded both inside and outside of Canada; or
 - (b) trades on the ATS
 - (i) in a specific ATS security of a particular issuer are equal to or greater than 50 percent of the average daily dollar value of the trading volume in that security
 - (A) on all marketplaces in Canada, if the ATS security is traded only in Canada, and
 - (B) on all marketplaces inside and outside of Canada, if the ATS security is traded both inside and outside of Canada; and
 - (ii) in any type of ATS security are equal to or greater than five percent of the

average daily dollar value of the trading volume in that type of security

- (A) on all marketplaces in Canada, if the type of ATS security is traded only in Canada, and
- (B) on all marketplaces inside and outside Canada, if the type of ATS security is traded both inside and outside of Canada.

- (2) An ATS shall provide the notice referred to in subsection (1) within ten days after the volume thresholds in subsection (1) are met or exceeded.

6.6 Prohibition Against Principal Trading - A securityholder of an ATS and an affiliated entity of that securityholder shall not buy or sell securities on that ATS for their own account.

6.7 Confidential Treatment of Trading Information

- (1) An ATS shall not release a subscriber's trading information to a person or company, other than the subscriber, unless
 - (a) the subscriber has consented in writing to the release of the information;
 - (b) the release of the information is required by this Instrument or under applicable law; or
 - (c) the information has been publicly disclosed by another person or company, and the disclosure was lawful.
- (2) An ATS shall not carry on business unless it has implemented reasonable safeguards and procedures to protect a subscriber's trading information, including
 - (a) limiting access to the trading information of subscribers to
 - (i) employees of the ATS, or
 - (ii) persons or companies retained by the ATS to operate the system or to be responsible for compliance by the ATS with Canadian securities legislation; and
 - (b) implementing standards controlling trading by employees of the ATS for their own accounts.
- (3) An ATS shall not carry on business unless it has implemented adequate oversight procedures to ensure that the safeguards and procedures established under subsection (2) are followed.

(4) Nothing in this section shall prohibit an ATS from complying with National Instrument 54-101 Communication with Beneficial Owners of Securities of a Reporting Issuer.⁵

6.8 Name - An ATS shall not use in its name the word "exchange", the words "stock market" or any derivations of those terms.

PART 7 INFORMATION TRANSPARENCY REQUIREMENTS FOR MARKETPLACES

7.1 Pre-trade Information Transparency

(1) A marketplace that displays orders to a person or company shall provide to the data consolidator, in the format required by the data consolidator, information regarding the total disclosed volume at each of the five best bid price and ask price levels for each security traded on the marketplace.

(2) Subsection (1) does not apply if the marketplace only displays orders to its own employees or persons or companies retained by the marketplace to assist in the operation of the marketplace.

7.2 Post-trade Information Transparency - A marketplace shall provide to the data consolidator, in the format required by the data consolidator, accurate and timely information regarding details of all trades executed on the marketplace, including details as to volume, symbol, price and time of the trade.

7.3 Consolidated Feed - The data consolidator shall produce a consolidated feed showing the information provided to the data consolidator under sections 7.1 and 7.2 and the identity of the marketplace on which each trade took place, but shall not disclose information about the identity of the buyer and seller of the securities traded.

PART 8 MARKET INTEGRATION FUNCTION FOR MARKETPLACES⁶

8.1 Market Integration Function for Marketplaces

⁵ This section is necessary because an investment dealer that operates as an ATS may be an intermediary for the purposes of National Instrument 54-101 and required to disclose information under that Instrument.

⁶ The Discussion Paper entitled "Consolidation Plan for a Consolidated Canadian Market", which is being published with this Instrument explains the market integration function in more detail and its phased-in implementation.

(1) A marketplace that is subject to section 7.1 shall comply with the requirements of the market integrator to provide for access to orders displayed through the data consolidator.

(2) When receiving an order from another marketplace, the marketplace receiving the order shall apply its own rules to the execution of that order.

(3) A marketplace shall provide to marketplace participants of any other marketplace access to the orders it displays to the data consolidator that is equivalent to the access that the marketplace provides to its own marketplace participants.

PART 9 DISCLOSURE OF TRANSACTION FEES FOR MARKETPLACE

9.1 Disclosure of Transaction Fees for Marketplace - If a marketplace charges a transaction fee that is greater than \$0.005 per security purchased or sold, the marketplace shall disclose that transaction fee in the ask price or bid price displayed by it.

PART 10 RECORDKEEPING REQUIREMENTS FOR MARKETPLACES

10.1 Business Records - A marketplace shall keep such records as are necessary for the proper recording of its business.

10.2 Other Records - In addition to the records required to be maintained under section 10.1, a marketplace shall keep

(a) a record of all marketplace participants who have been granted access to trading in the marketplace; and

(b) daily trading summaries for the marketplace, including

(i) securities traded,

(ii) transaction volumes

(A) for shares and derivatives of shares, expressed as number of issues traded, number of trades, total unit volume and total dollar value of trades and, if the price of the securities traded is quoted in a currency other than Canadian dollars, the total value in that currency, and

(B) for debt securities, expressed as the number of trades and total

dollar value traded and, if the price of the securities traded is quoted in a currency other than Canadian dollars, the total value in that currency,

- (iii) time sequenced records of order information in the system, including
 - (A) date and time, expressed in hours, minutes and seconds, that the order was received and entered,
 - (B) details of the order, including identity of the security, designation as a buy or sell, quantity specified and all designated price parameters including market order and applicable price limits,
 - (C) all other order modifiers, including time limit in force, short sale, and special terms,
 - (D) all instructions to modify or cancel the order,
 - (E) all execution report details, including amount of the order executed, the price at which the order was executed, time of execution and identity of the counterparty, and
 - (F) time sequenced records of all messages sent to or received from the data consolidator, the market integrator and any other marketplace.

10.3 Record preservation requirements

- (1) For a period of not less than seven years from the creation of a record referred to in this section, and for the first two years in a readily accessible location, a marketplace shall keep
 - (a) all records required to be made under sections 10.1 and 10.2;
 - (b) at least one copy of its standards for granting access to trading, if any, all records relevant to its decision to grant, deny or limit access to a person or company and, if applicable, all other records made or received by the marketplace in the course of complying with section 5.1;
 - (c) at least one copy of all records made or received by the marketplace in the course of complying with section 11.1, including all

correspondence, memoranda, papers, books, notices, accounts, reports, test scripts, test results, and other similar records;

- (d) if the marketplace is an ATS and it is not required to comply with section 11.1, at least one copy of all records made or received by the marketplace in the course of carrying out any activities of a type described in paragraphs (a) to (g) of section 11.1, including all correspondence, memoranda, papers, books, notices, accounts, reports, test scripts, test results, and other similar records related to those activities; and
 - (e) all written notices provided by the marketplace to marketplace participants generally, including notices addressing hours of system operations, system malfunctions, changes to system procedures, maintenance of hardware and software, instructions pertaining to access to the marketplace and denials of, or limitation to, access to the marketplace.
- (2) During the period in which a marketplace is in existence, the marketplace shall keep
 - (a) all organizational documents, minute books and stock certificate books;
 - (b) in the case of a recognized exchange, copies of all forms filed under Part 3;
 - (c) in the case of a recognized quotation and trade reporting system, copies of all forms filed under Part 4; and
 - (d) in the case of an ATS, copies of all forms filed under sections 6.2 and 6.3 and notices given under sections 6.4 and 6.5.

10.4 Means of Record Preservation - A marketplace may keep all records, documents and forms referred to in this Part by means of mechanical, electronic or other devices, if

- (a) such method of recordkeeping is not prohibited under other applicable law;
- (b) the marketplace takes adequate precautions, appropriate to the means used, to govern against the risk of falsification of the information recorded; and
- (c) the marketplace provides a means for making the information available in an accurate and intelligible form, capable of being printed, within a reasonable time to

any person or company lawfully entitled to examine the records.

PART 11 CAPACITY, INTEGRITY AND SECURITY OF MARKETPLACE SYSTEMS

11.1 System Requirements - An ATS that is subject to this section, a recognized exchange and a recognized quotation and trade reporting system shall, for each of their systems that support order entry, order routing, execution, trade reporting and trade comparison,

- (a) make reasonable current and future capacity estimates;
- (b) conduct capacity stress tests of critical systems on a reasonably frequent basis to determine the ability of those systems to process transactions in an accurate, timely and efficient manner;
- (c) develop and implement reasonable procedures to review and keep current the development and testing methodology of those systems;
- (d) review the vulnerability of those systems and data centre computer operations to internal and external threats, including physical hazards, and natural disasters;
- (e) establish reasonable contingency and business continuity plans;
- (f) on an annual basis, perform an independent review, in accordance with established audit procedures and standards, of their controls for ensuring that each of them is in compliance with paragraphs (a) through (e), and conduct a review by senior management of a report containing the recommendations and conclusions of the independent review; and
- (g) promptly notify the securities regulatory authority of material systems failures and changes.

11.2 Application - Section 11.1 applies to an ATS once trades on the ATS in any type of ATS security, during at least four of any six consecutive calendar months, are greater than 20 percent of the average daily dollar value of the trading volume in that type of security

- (a) on all marketplaces in Canada if the ATS security is traded only in Canada; and
- (b) on all marketplaces inside and outside of Canada, if the ATS security is traded both inside and outside of Canada.

PART 12 EXEMPTION

12.1 Exemption

- (1) The regulator or the securities regulatory authority may grant an exemption from this Instrument, in whole or in part, subject to such conditions or restrictions as may be imposed in the exemption.
- (2) Despite subsection (1), in Ontario, only the regulator may grant such an exemption.

**APPENDIX A
TO
NATIONAL INSTRUMENT 21-101
MARKETPLACE OPERATION**

FOREIGN MARKETS

1. The American Stock Exchange
2. The New York Stock Exchange
3. The London Stock Exchange Limited
4. The Nasdaq Stock Market

Forms 21-101F1 - 21-101F4

EXHIBITS

File all Exhibits with an application for registration. For each exhibit, include the name of the exchange or quotation and trade reporting system, the date of filing of the exhibit and the date as of which the information is accurate (if different from the date of the filing). If any Exhibit required is inapplicable, a statement to that effect shall be furnished instead of such Exhibit.

If the applicant, recognized exchange or recognized quotation and trade reporting system files an amendment to this Form and the amendment relates to an Exhibit to this Form, the applicant, recognized exchange or recognized quotation and trade reporting system, as the case may be, must, in order to comply with section 3.2 or 4.2 of National Instrument 21-101, file the Exhibit to which the amendment relates showing the changes and provide an updated version of the Exhibit.

Exhibit A A copy of the constating documents with all subsequent amendments, and of existing by-laws or corresponding rules or instruments, whatever the name, of the exchange or quotation and trade reporting system.

Exhibit B A copy of all rules, regulations, policies, procedures, interpretations, practices and other similar instruments of the exchange or quotation and trade reporting system that are not included in Exhibit A.

Exhibit C For each affiliated entity of the exchange or quotation and trade reporting system, and for any person or company with whom the exchange or quotation and trade reporting system has a contractual or other agreement relating to the operation of an electronic trading system to be used to effect transactions on the exchange or quotation and trade reporting system (the "System"), provide the following information:

1. Name and address of person or company.
2. Form of organization (e.g., association, corporation, partnership, etc.)
3. Name of location and statute citation under which organized. Date of incorporation in present form.
4. Brief description of nature and extent of affiliation or contractual or other agreement with exchange or quotation and trade reporting system.
5. Brief description of business or functions. Description should include responsibilities with respect to operation of the System and/or execution, reporting, clearance, or settlement of transactions in connection with operation of the System.
6. If a person or company has ceased to be an affiliated entity of the exchange or quotation and trade reporting system during the previous year or ceased to have a contractual or other agreement relating to the operation of a System during the previous year, provide a brief statement of the reasons for termination of the relationship.

Exhibit D Describe the manner of operation of the System. This description should include the following:

1. The means of access to the System.
2. Procedures governing entry and display of quotations and orders in the System.
3. Procedures governing the execution, reporting, clearance and settlement of transactions in connection with the System.
4. Proposed fees.
5. Procedures for ensuring compliance with System usage guidelines.
6. The hours of operation of the System, and the date on which exchange or quotation and trade reporting system intends to commence operation of the System.
7. Attach a copy of the users' manual.
8. If the exchange or quotation and trade reporting system proposes to hold funds or securities on a regular basis, describe the controls that will be implemented to ensure safety of those funds or securities.

Exhibit E A complete set of all forms pertaining to:

1. Application for participation in the exchange or quotation and trade reporting system.
2. Any other similar materials.

Exhibit F A complete set of all forms of financial statements, reports or questionnaires required of marketplace participants relating to financial responsibility or minimum capital requirements for such marketplace participants. Provide a table of contents listing the forms included in this Exhibit.

Exhibit G A complete set of documents comprising the exchange's or quotation and trade reporting system's listing or quotation applications, including any agreements required to be executed in connection with listing or quotation and a schedule of listing or quotation fees. If the exchange or quotation and trade reporting system does not list securities, provide a brief description of the criteria used to determine what securities may be traded on the exchange or quotation and trade reporting system. Provide a table of contents listing the forms included in this Exhibit.

Exhibit H For the latest financial year of the exchange or quotation and trade reporting system, audited financial statements of the exchange or quotation and trade reporting system which are prepared in accordance with, or in the case of a foreign exchange or quotation and trade reporting system, reconciled with, Canadian GAAP, and are covered by a report prepared by an independent auditor.

Exhibit I A list of the partners, directors, officers, governors, members of all standing committees, or persons performing similar functions, who presently hold or have held their offices or positions during the previous year, indicating the following for each:

1. Name.
2. Title.
3. Dates of commencement and termination of term of office or position.
4. Type of business in which each is primarily engaged (e.g., sales trading, market making, etc.).
5. For partners, directors, officers, governors or persons performing similar functions, the type of business in which each was primarily engaged in the preceding five years, if different from that set out in item 4.

Exhibit J For each affiliated entity of the exchange or quotation and trade reporting system, provide the following information:

1. A copy of the constating documents.
2. A copy of existing by-laws or corresponding rules or instruments.
3. The name and title of the present officers, governors, members of all standing committees or persons performing similar functions.
4. For the latest financial year of the affiliated entity, unconsolidated financial statements, which may be unaudited. Such financial statements shall consist, at a minimum, of a balance sheet and an income statement prepared in accordance with, or if the affiliated entity is organized under the laws of a foreign jurisdiction, reconciled with Canadian GAAP. If the affiliated entity is required by securities legislation to file annual financial statements, a statement to that effect, with a reference to the relevant securities legislation, may be provided instead of the financial statements required.

Exhibit K This Exhibit is applicable only to exchange or quotation and trade reporting systems that have one or more owners, shareholders, or partners that are not also marketplace participants. If the exchange or quotation and trade reporting system is a corporation, please provide a list of each shareholder that directly owns five percent or more of a class of a voting security of the exchange or quotation and trade reporting system. If the exchange or quotation and trade reporting system is a partnership, please provide a list of all general partners and those limited partners that have the right to receive upon dissolution, or have contributed, five percent or more of the partnership's capital. For each of the persons listed in this Exhibit, please provide the following information:

1. Full legal name.
2. Title or status.
3. Date title or status was acquired.
4. Approximate ownership interest.
5. Whether the person has control (as interpreted in subsection 1.3(2) of National Instrument 21-101 Marketplace Operation).

Exhibit L Describe the exchange's or quotation and trade reporting system's criteria for participation in the exchange or quotation and trade reporting system. Describe conditions under which marketplace participants may be subject to suspension or termination with regard to access to the exchange or quotation and trade reporting system. Describe any procedures that will be involved in the suspension or termination of a member.

Exhibit M Provide an alphabetical list of all marketplace participants, including the following information:

1. Name.
2. Date of becoming a marketplace participant.
3. Principal business address and telephone number.
4. If a marketplace participant, is an individual, the name of the entity with which such individual is associated and the relationship of such individual to the entity (e.g., partner, officer, director, employee, etc.).
5. Describe the type of trading activities primarily engaged in by the marketplace participant (e.g., agency trading, principal trading, registered trader, market maker). A person shall be "primarily engaged" in an activity or function for purposes of this item when that activity or function is the one in which that person is engaged for the majority of their time. When more than one type of person at an entity engages in any of the activities or functions enumerated in this item, identify each type (e.g., agency trader, registered trader and market maker) and state the number of marketplace participants in each.
6. The class of participation or other access.

Exhibit N Provide a schedule for each of the following:

1. The securities listed on the exchange or quoted on the quotation and trade reporting system, indicating for each the name of the issuer and a description of the security.
2. Other securities traded on the marketplace, including, for each, the name of the issuer and a description of the security.

**CERTIFICATE OF EXCHANGE OR QUOTATION AND
TRADE REPORTING SYSTEM**

The undersigned certifies that the information given in this report is true and correct.

DATED at _____ this ____ day of _____ 20__

(Name of exchange or quotation and trade reporting system)

(Name of director, officer or partner - please type or print)

(Signature of director, officer or partner)

(Official capacity- please type or print)

**NATIONAL INSTRUMENT 21-101
FORM 21-101F2
INITIAL OPERATION REPORT AND AMENDMENT TO INITIAL OPERATION REPORT
FOR ALTERNATIVE TRADING SYSTEM**

Initial Report Amendment to Initial Operation Report

1. Identification:

A. Full name of alternative trading system (if sole proprietor, last, first and middle name):

B. Name(s) under which business is conducted, if different from item 1A:

C. If this filing makes a name change on behalf of the alternative trading system in respect of the name set out in Item 1A or Item 1B, enter the previous name and the new name.

Previous name: _____

New name: _____

D. Alternative trading system's main street address:

E. Mailing address (if different):

F. Address of head office (if different from address in item D):

G. Business telephone and facsimile number:

(Telephone)

(Facsimile)

H. Website address:

I. Contact Employee:

(Name and Title)

(Telephone Number)

(Facsimile)

(E-mail address)

2. If this is an initial operation report, the date the alternative trading system expects to commence operation:

3. Attach as Exhibit A, a description of classes of subscribers (e.g., dealer, institution, or retail). Also describe any differences in access to the services offered by the alternative trading system to different groups or classes of subscribers.
4. Attach as Exhibit B:
 - (a) A list of the types of securities the alternative trading system trades (e.g., debt, shares) or if this is an initial operation report, the types of securities it expects to trade.
 - (b) A list of each of the securities the alternative trading system trades, or if this is an initial operation report, the securities it expects to trade.
5. Attach as Exhibit C, the name, address, telephone number, facsimile number and e-mail address of counsel for the alternative trading system.
6. Attach as Exhibit D, a copy of the constating documents with all amendments, and of existing by-laws or corresponding rules or instruments, whatever the name, of the alternative trading system.
7. Attach as Exhibit E, the name of any person or company, other than the alternative trading system, that will be involved in the operation of the alternative trading system, including the execution, trading, clearing and settling of transactions on behalf of the alternative trading system. Provide a description of the role and responsibilities of each person or company.
8. Attach as Exhibit F, the following information:
 - (a) The manner of operation of the alternative trading system.
 - (b) Procedures governing entry of orders into the alternative trading system.
 - (c) The means of access to the alternative trading system.
 - (d) Fees charged by the alternative trading system.
 - (e) The procedures governing execution, reporting, clearance and settlement of transactions effected through the alternative trading system.
 - (f) Procedures for ensuring subscriber compliance with requirements of the alternative trading system.
 - (g) A description of safeguards and procedures implemented by the alternative trading system to protect subscriber's trading information.
 - (h) A copy of the alternative trading system's subscriber manual and any other materials provided to subscribers.
 - (i) A schematic diagram showing the architecture of the alternative trading system including communications network, processors, front end devices, gateways, firewalls and external systems connectors.
9. Attach as Exhibit G, a brief description of the alternative trading system's procedures for reviewing system capacity, security and contingency planning procedures.
10. If any other person or company, other than the alternative trading system, will hold or safeguard subscriber funds or securities on a regular basis, attach as Exhibit H the name of the person or company and a brief description of the controls that will be implemented to ensure the safety of the funds and securities.
11. Attach as Exhibit I, a list of the full legal name of registered holders and beneficial owners of securities of the alternative trading system.
12. If an ATS files an amendment to this Form and the amendment relates to an Exhibit to this Form, the ATS must, in order to comply with subsection 6.2(2) or 6.2(3) of National Instrument 21-101, file the Exhibit to which the amendment relates showing the changes and provide an updated version of the Exhibit.

CERTIFICATE OF ALTERNATIVE TRADING SYSTEM

The undersigned certifies that the information given in this report is true and correct.

DATED at _____ this _____ day of _____ 20__

(Name of alternative trading system)

(Name of director, officer or partner - please type or print)

(Signature of director, officer or partner)

(Official capacity- please type or print)

**NATIONAL INSTRUMENT 21-101
FORM 21-101F3
QUARTERLY REPORT OF ALTERNATIVE TRADING SYSTEM ACTIVITIES**

Alternative Trading System Name: _____

Period covered by this report: _____ to _____

1. Identification:

A. Full name of alternative trading system (if sole proprietor, last, first and middle name):

B. Name(s) under which business is conducted, if different from item 1A:

C. Alternative trading system's main street address:

2. Attach as Exhibit A, a list of all subscribers at any time during the period covered by this report.

3. Attach as Exhibit B, a list of all securities that were traded on the alternative trading system at any time during the period covered by this report.

4. Provide the total unit and dollar value of transactions in the following securities during regular trading hours. Enter "N/A" or "0" where appropriate.

Category of Securities	Total Unit Volume of Transactions	Total Dollar Volume of Transactions (Cdn\$)
A. Listed shares		
Domestic		
Foreign		
B. Listed debt securities		
Domestic		
Foreign		
C. Unlisted shares		
Domestic		
Foreign		
D. Unlisted debt securities (non-government)		
Domestic		
Foreign		
E. Government debt securities		
Domestic		
Foreign		
F. Listed Options		
Domestic		
Foreign		

Category of Securities	Total Unit Volume of Transactions	Total Dollar Volume of Transactions (Cdn\$)
G. Unlisted options		
Domestic		
Foreign		
H. Other		
Specify types of securities		

5. Provide the total unit and dollar value of transactions in the following securities for after-hours trading. Enter "None", "1" or "0" where appropriate.

Category of Securities	Total Unit Volume of Transactions	Total Dollar Volume of Transactions (Cdn\$)
A. Listed shares		
Domestic		
Foreign		
B. Listed debt securities		
Domestic		
Foreign		
C. Unlisted shares		
Domestic		
Foreign		
D. Unlisted debt securities (non-government)		
Domestic		
Foreign		
E. Government debt securities		
Domestic		
Foreign		
F. Listed options		
Domestic		
Foreign		
G. Unlisted options		
Domestic		
Foreign		
H. Other		
Specify types of securities		

6. Attach as Exhibit C, a list of all persons granted, denied, or limited access to the alternative trading system during the period covered by this report, designating for each person (a) whether they were granted, denied, or limited access; (b) the date the alternative trading system took such action; (c) the effective date of such action; and (d) the nature of any denial or limited access.

CERTIFICATE OF ALTERNATIVE TRADING SYSTEM

The undersigned certifies that the information given in this report relating to the alternative trading system is true and corre

DATED at _____ this ____ day of _____ 20__

(Name of alternative trading system)

(Name of director, officer or partner - please type or print)

(Signature of director, officer or partner)

(Official capacity - please type or print)

**NATIONAL INSTRUMENT 21-101
FORM 21-101F4
CESSATION OF OPERATIONS REPORT FOR
ALTERNATIVE TRADING SYSTEM**

1. Identification:

A. Full name of alternative trading system (if sole proprietor, last, first and middle name):

B. Name(s) under which business is conducted, if different from item 1A:

2. Date alternative trading system proposes to cease carrying on business: _____

3. If cessation of business was involuntary, date alternative trading system has ceased to carry on business:

4. Attach as Exhibit A the reasons for the alternative trading system ceasing to carry on business.

5. Attach as Exhibit B a list of each of the securities the alternative trading system trades.

6. Attach as Exhibit C the amount of funds and securities, if any, held for subscribers by the alternative trading system, or another person or company retained by the alternative trading system to hold funds and securities for subscribers and the procedures in place to return all funds and securities to subscribers.

CERTIFICATE OF ALTERNATIVE TRADING SYSTEM

The undersigned certifies that the information given in this report is true and correct.

DATED at _____ this _____ day of _____ 20__

(Name of alternative trading system)

(Name of director, officer or partner - please type or print)

(Signature of director, officer or partner)

(Official capacity - please type or print)

Companion Policy 21-101CP - Marketplace Operation

**COMPANION POLICY 21-101CP
TO NATIONAL INSTRUMENT 21-101
MARKETPLACE OPERATION**

12.1 Recordkeeping Requirements for
Marketplaces

PART 13 CAPACITY, INTEGRITY AND SECURITY OF
MARKETPLACE SYSTEMS
13.1 Capacity, Integrity and Security of
Marketplace Systems

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**COMPANION POLICY 21-101CP
TO NATIONAL INSTRUMENT 21-101
MARKETPLACE OPERATION**

PART 1 INTRODUCTION

1.1 Introduction - Traditionally, the Canadian securities regulatory authorities have regulated securities markets by regulating dealers, exchanges, and, in some jurisdictions, quotation and trade reporting systems. In recent years, particularly in the United States, new types of markets have emerged that take different forms than a traditional exchange or quotation and trade reporting system and trade securities in a different manner than on those markets. These entities are referred to as alternative trading systems. While the existing regulatory system will generally apply to the activities engaged in by these markets, there are instances where the existing regulatory system needs to be supplemented. Accordingly, the Canadian securities regulatory authorities have adopted National Instrument 21-101 Marketplace Operation (the "Instrument") to create an appropriate regulatory regime to deal with these new types of markets and to supplement the regime applicable to exchanges and quotation and trade reporting systems.

The purpose of this Companion Policy is to state the views of the Canadian securities regulatory authorities on various matters related to the Instrument including

- (a) a discussion of the general approach taken by the Canadian securities regulatory authorities in, and the general regulatory purpose for, the Instrument; and
- (b) the interpretation of various terms and provisions in the Instrument.

PART 2 MARKETPLACE

2.1 Marketplace

- (1) The Instrument uses the term "marketplace" to encompass the different types of trading systems that match trades. Each of an exchange, a quotation and trade reporting system, and an alternative trading system is a marketplace for purposes of the Instrument.
- (2) Two of the characteristics of a "marketplace" are that it brings together orders for securities of multiple buyers and sellers and uses established, non-discretionary methods under which the orders interact with each other.

- (3) The Canadian securities regulatory authorities consider that a person or company brings together orders for securities if it displays, or otherwise represents to marketplace participants, trading interests entered on the system or receives orders centrally for processing and execution. This applies regardless of the level of automation used.
- (4) The Canadian securities regulatory authorities are of the view that "established, non-discretionary methods" include any methods that dictate the terms of trading among the multiple buyers and sellers entering orders on the system. Such methods include providing a trading facility or setting rules governing trading among marketplace participants. Common examples include a traditional exchange and a computer system, whether comprised of software, hardware, protocols, or any combination thereof, through which orders interact, or any other trading mechanism that provides a means or location for the bringing together and execution of orders. Rules imposing execution priorities, such as time and price priority rules, would be "established, non-discretionary methods."
- (5) The Canadian securities regulatory authorities do not consider the following systems to be marketplaces for purposes of the Instrument:
 - 1. A system operated by a person or company that only permits one seller to sell its securities, such as a system that permits issuers to sell their own securities to investors.
 - 2. A system that merely routes orders for execution to a facility where the orders are executed.
 - 3. A system that merely provides information to marketplace participants about other marketplace participant's trading interests, without facilities for execution.

In the first two cases, the criteria of multiple buyers and sellers would not be met. In addition, in the last two cases, routing systems and bulletin boards do not establish non-discretionary methods under which parties entering orders interact with each other. The Canadian securities regulatory authorities are of the view that a dealer that uses internal systems to trade and manage orders would not be a marketplace, if the dealer exercises discretion or judgement over customer orders.

- (6) A person or company operating any of the systems described in subsection (5) should consider whether the person or company is trading for the purposes of securities legislation

and is required to be registered under securities legislation.

PART 3 CHARACTERISTICS OF EXCHANGES, QUOTATION AND TRADE REPORTING SYSTEMS AND ATSS

3.1 Exchange

- (1) Canadian securities legislation prohibits a person or company from carrying on business as an exchange unless recognized by the securities regulatory authority. Canadian securities legislation of most jurisdictions does not define the term exchange.
- (2) The Canadian securities regulatory authorities generally consider a marketplace to be an exchange for purposes of securities legislation, if the marketplace
 - (a) requires an issuer to enter into an agreement in order for the issuer's securities to trade on the marketplace, *i.e.*, the marketplace provides a listing function;
 - (b) provides, directly, or through one or more marketplace participants, a guaranteed minimum size order for any securities traded on the marketplace for the purposes of ensuring liquidity for those securities, *i.e.*, the marketplace has one or more marketplace participants that guarantee that they will fill a minimum specified quantity of an issue based on specific parameters (*e.g.*, at the prevailing bid ask). This type of liquidity guarantee has historically been carried out on exchanges through traders, acting as principals, on behalf of their firms such as registered traders, specialists or market makers;
 - (c) sets requirements governing the conduct of marketplace participants, in addition to conduct in respect of the trading by those marketplace participants on the system (see subsection (3)); or
 - (d) disciplines marketplace participants, in addition to discipline by exclusion from trading, *i.e.*, the marketplace can levy fines or take enforcement actions.
- (3) In respect of paragraph (c) of subsection (2), the Canadian securities regulatory authorities would consider a marketplace to be setting requirements governing the conduct of marketplace participants if it imposes on marketplace participants, as a condition of

participation in the marketplace, any requirements for which the marketplace has to examine marketplace participants for compliance, such as anti-manipulation requirements or requirements related to surveillance and enforcement. In addition, if a marketplace imposes as a condition of participation, directly or indirectly, restrictions on a marketplace participant's activities outside of the marketplace, the Canadian securities regulatory authorities are of the view that the marketplace sets requirements governing the conduct of marketplace participants. This limitation would not preclude a marketplace from imposing credit conditions on subscribers or requiring subscribers to submit financial information to the marketplace.

Paragraph (c) of subsection (2) contains an exclusion for conduct in respect of trading by marketplace participants on the system. This is a reference to a marketplace having in place trading algorithms that provide that a trade takes place if certain events occur. This exclusion is necessary as those algorithms could otherwise be considered to be conduct in respect of the trading by the marketplace participants on the system.

- (4) The criteria in subsection (2) are not exclusive and there may be other instances in which the Canadian securities regulatory authorities will consider a marketplace to be an exchange.
- (5) Subsection 6.5(1) of the Instrument requires an ATS to notify the securities regulatory authority if trades on the ATS for any three of the ATS's previous four calendar quarters meet or exceed certain volume thresholds.
- (6) Upon being informed of the volume thresholds referred to in subsection (5) being met or exceeded, the securities regulatory authority intends to review the ATS, its structure and operations in order to consider whether the person or company operating the ATS should be considered to be an exchange for purposes of securities legislation. The securities regulatory authority intends to conduct this review because the volume thresholds may be indicative of an ATS having market dominance over a type of security or a security of a particular issuer, such that it would be more appropriate that that marketplace be regulated as an exchange. If more than one Canadian securities regulatory authority is conducting this review, the reviewing jurisdictions intend to coordinate their review.
- (7) The volume thresholds referred to in paragraph 6.5(1)(a), subparagraph 6.5(1)(b)(ii) and section 11.2 of the Instrument are based on type of security. The Canadian securities

regulatory authorities consider a type of security to refer to a distinctive form of security such as an equity security¹, a preferred share, a debt security or an option.

3.2 Quotation and Trade Reporting System

- (1) Canadian securities legislation in certain jurisdictions contains the concept of a quotation and trade reporting system. A quotation and trade reporting system is defined under Canadian securities legislation in those jurisdictions as a person or company, other than an exchange or registered dealer, that operates facilities that permit the dissemination of price quotations for the purchase and sale of securities and reports of completed transactions in securities for the exclusive use of registered dealers. A person or company that carries on business as a vendor of market data would not normally be considered to be a quotation and trade reporting system.
- (2) A person or company cannot carry on business as a quotation and trade reporting system in those jurisdictions unless it is recognized appropriately in the local jurisdiction, or it is an ATS that is in compliance with the Instrument.

3.3 ATS

- (1) In order to be an ATS for the purposes of the Instrument, a marketplace cannot engage in certain activities or meet certain criteria such as requiring listing agreements, having market makers, setting rules governing the conduct of subscribers or disciplining subscribers. A marketplace, other than a quotation and trade reporting system, that engages in these activities or meets these criteria would in the view of the Canadian securities regulatory authorities be an exchange and would have to be recognized as such in order to carry on business.
- (2) Under subsection 7.1(3) of National Instrument 23-101 Trading Rules, an ATS is required to enter into an agreement with an agent to monitor and enforce compliance with the requirements of that Instrument. The Canadian securities regulatory authorities do not consider that, by entering into such an agreement, an ATS will be disciplining subscribers such that it would lose its status as an ATS.

- (3) A marketplace that would otherwise meet the definition of an ATS in the Instrument may apply to the Canadian securities regulatory authorities for recognition as an exchange.
- (4) Part 6 of the Instrument applies only to an ATS that is not a recognized exchange or a member of an exchange. If an ATS is recognized as an exchange, the provisions of the Instrument relating to marketplaces and recognized exchanges apply.
- (5) If the ATS is a member of an exchange, the by-laws, rules, regulations, policies, procedures, practices, interpretations and other similar instruments of the exchange apply to the ATS.
- (6) Under paragraph (a) of section 6.1 of the Instrument, an ATS that is not a member of a recognized exchange must register as a dealer if it wishes to carry on business. The requirements imposed by the Instrument are in addition to any requirements applicable to dealers registered under Canadian securities legislation.
- (7) Paragraph (b) of section 6.1 prohibits an ATS to which the provisions of the Instrument apply from carrying on business unless it is a member of a self-regulatory entity. Membership in a self-regulatory entity is required for purposes of membership in the Canadian Investor Protection Fund, capital requirements and clearing and settlement procedures. At this time, the Investment Dealers Association of Canada is the only entity that would come within the definition.
- (8) Section 6.6 of the Instrument prohibits a securityholder of an ATS and an affiliated entity of that securityholder from buying or selling securities on that ATS for their own account. This section does not prevent those persons or companies from trading on another marketplace either as agent or principal.
- (9) As an ATS may only trade ATS securities, any reference in the Instrument to securities trading on an ATS is to ATS securities.

PART 4 SELECTION OF DATA CONSOLIDATOR AND MARKET INTEGRATOR

- ### 4.1 Selection of Data Consolidator and Market Integrator
- The data consolidator and market integrator under the Instrument is a person or company selected by the Canadian securities regulatory authority in each jurisdiction. It is the intention of the Canadian securities regulatory authorities in each jurisdiction that adopts the Instrument to act together in selecting the data consolidator and market integrator.

¹ The term "equity security" is defined in National Instrument 14-101 Definitions as having the meaning ascribed to that term in securities legislation.

PART 5 RECOGNITION AS AN EXCHANGE OR QUOTATION AND TRADE REPORTING SYSTEM

5.1 Recognition as an Exchange or Quotation and Trade Reporting System

- (1) In determining whether to recognize an exchange or quotation and trade reporting system, the Canadian securities regulatory authorities must determine whether it is in the public interest to do so.
- (2) In exercising this discretion the Canadian securities regulatory authorities will look at a number of factors, including
 - (a) the manner in which the exchange or quotation and trade reporting system proposes to comply with the Instrument;
 - (b) whether the exchange or quotation and trade reporting system has fair and meaningful representation on its governing body, in the context of the nature and structure of the exchange or quotation and trade reporting system;
 - (c) whether the exchange or quotation and trade reporting has sufficient financial resources for the proper performance of its functions; and
 - (d) whether the by-laws, rules, regulations, policies, procedures, practices, interpretations and other similar instruments of the exchange or quotation and trade reporting system ensure that its business is conducted in an orderly manner so as to afford protection to investors.

PART 6 ORDERS

6.1 Bid and Ask Prices - The terms "ask price" and "bid price" are defined in section 1.1 of the Instrument as the price of an order to sell or to buy at least one board lot. The term "order" is discussed in section 6.2.

6.2 Order

- (1) The term "order" is defined in section 1.1 of the Instrument as a firm indication by a person or company, acting as either principal or agent, of a willingness to buy or sell a security. By virtue of this definition, a marketplace that displays good faith, non-firm indications of interest, including, but not limited to, indications of interest to buy or sell a particular security without either prices or quantities

associated with those indications is not displaying "orders".

- (2) The label put on a transaction is not determinative of whether the transaction constitutes an order. Instead, whether or not an indication is "firm" will depend on what actually takes place between the buyer and seller. At a minimum, the Canadian securities regulatory authorities will consider an indication to be firm if it can be executed without further agreement of the person or company entering the indication. Even if the person or company must give its subsequent agreement to an execution, the Canadian securities regulatory authorities will still consider the indication to be firm if this subsequent agreement is always, or almost always, granted so that the agreement is largely a formality. For instance, an indication where there is a clear or prevailing presumption that a trade will take place at the indicated price, based on understandings or past dealings, will be viewed as an order.
- (3) A firm indication of a willingness to buy or sell a security includes bid or offer quotations, market orders, limit orders and any other priced orders. The Canadian securities regulatory authorities do not consider special terms orders such as all or none, minimum fill, or cash or delay delivery to be firm indications.
- (4) The determination of whether an order has been placed does not turn on the level of automation used. Orders can be given over the telephone, as well as electronically.

PART 7 FORMS FILED BY MARKETPLACES

7.1 Forms Filed by Marketplaces

- (1) The forms filed by a marketplace under the Instrument will be open for public inspection unless the person or company filing the form applies to the securities regulatory authority to keep the form confidential and the securities regulatory authority agrees to do so. In determining whether to keep a form confidential, the securities regulatory authority will look at the type of information on the form and determine whether the desirability of avoiding disclosure outweighs the desirability of public disclosure.
- (2) Under subsection 6.2(2) of the Instrument, an ATS is required to file an amendment to Form 21-101F2 at least 30 days before implementing a change to its operations that is significant. The Canadian securities regulatory authorities consider that a significant change to the operations of an ATS includes any change to

the operating platform of an ATS, the types of securities traded, or the types of subscribers.

- (3) Subsection 6.2(4) of the Instrument requires an ATS to file Form 21-101F3 by the following dates: April 30 (for the quarter ending March 31), July 30 (for the quarter ending June 30), October 30 (for the quarter ending September 30) and January 30 (for the quarter ending December 31).
- (4) Subsection 6.3(1) requires an ATS that intends to cease carrying on business to file Form 21-101F4 at least 30 days before ceasing to carry on business. This subsection applies to an ATS that voluntarily ceases to carry on business. Subsection 6.3(2) requires an ATS that involuntarily ceases to carry on business to file Form 21-101F4 as soon as practicable after it ceases to carry on business.

PART 8 CERTAIN REQUIREMENTS APPLICABLE ONLY TO EXCHANGES AND QUOTATION AND TRADE REPORTING SYSTEMS

- 8.1 Access Requirements** - Section 5.1 of the Instrument sets out access requirements that apply to a recognized exchange and a recognized quotation and trade reporting system. The Canadian securities regulatory authorities note that the obligation to ensure access for members does not, however, restrict the authority of an exchange or quotation and trade reporting system to maintain reasonable standards for access.
- 8.2 Discipline Rules** - Section 5.4 of the Instrument requires a recognized exchange and recognized quotation and trade reporting system to have appropriate discipline requirements for violations of securities legislation and the rules of the exchange and quotation and trade reporting system. This section does not preclude enforcement action by any other person or company, including the Canadian securities regulatory authorities.
- 8.3 By-law Review** - Section 5.5 of the Instrument requires a recognized exchange and recognized quotation and trade reporting system to file with the securities regulatory authority that recognized it all by-laws, rules, regulations, policies, procedures, practices, interpretations, and other similar instruments and amendments adopted by the exchange and quotation and trade reporting system. The securities regulatory authority will determine which of these instruments to review based on securities legislation and other factors.

PART 9 CONFIDENTIAL TREATMENT OF TRADING INFORMATION BY ATSS

9.1 Confidential Treatment of Trading Information by ATSS

- (1) Section 6.7 of the Instrument provides that an ATS shall not carry on business unless it has implemented reasonable safeguards and procedures to protect a subscriber's trading information. These include
 - (a) limiting access to the trading information of subscribers, such as the identity of subscribers and their orders, to those employees of, or persons or companies retained by, the ATS to operate the system or to be responsible for its compliance with Canadian securities legislation; and
 - (b) having in place procedures to ensure that employees of the ATS cannot use such information for trading in their own accounts.
- (2) The procedures referred to in subsection (1) should be clear and unambiguous and presented to all employees and agents of the ATS, whether or not they have direct responsibility for the operation of the ATS.

PART 10 INFORMATION TRANSPARENCY REQUIREMENTS FOR MARKETPLACES

10.1 Information Transparency Requirements for Marketplaces

- (1) Subsection 7.1(1) of the Instrument requires a marketplace that displays orders to any person or company, other than its own employees or persons or companies retained by it to assist in its operations, to provide to the data consolidator information regarding the total disclosed volume at each of the five best bid price and ask price levels for each security traded on the marketplace. The term "total disclosed volume" refers to the amount of the orders that is displayed in the marketplace. Volumes that are not disclosed or that are "reserve" or hidden volumes are not required to be displayed.
- (2) The Canadian securities regulatory authorities expect that information required to be provided to the data consolidator under the Instrument will be provided in real time or as close to real time as possible.

PART 11 MARKET INTEGRATION FUNCTION FOR MARKETPLACES²

11.1 Execution of Orders - Subsection 8.1(2) of the Instrument requires a marketplace, when receiving an order from another marketplace, to apply its own rules to the execution of that order. This requires a marketplace that displays orders through the data consolidator to provide access to its passive booked orders. The active order will be routed to the system in which the passive order is booked and execution will be completed according to the rules of the system in which the passive order is booked. A passive order is an order that has been placed in the order book because it was not executable at time of entry and is now waiting to be executed. An active order is an order that comes into the market seeking a counterparty that is either a market order or an executable limit order (a buy order with a limit at or above present ask price or a sell order with a limit at or below the present bid price).

² Part 8 of the Instrument contains the provisions applicable to market integration. After comments are received on the discussion paper on consolidation that accompanies publication of this Companion Policy, this Companion Policy may be amended to include further discussion of the phased-in market integration provisions.

11.2 Equivalent Access

- (1) The Canadian securities regulatory authorities believe that a marketplace participant should be able to execute against another marketplace orders that are provided to the data consolidator to the same extent as if that order had been reflected in the marketplace in which the marketplace participant is a member, a user or a subscriber. Accordingly, subsection 8.1(3) of the Instrument requires a marketplace to be able to receive from or send orders to other marketplaces to which it is linked.
- (2) Examples of where the Canadian securities regulatory authorities would consider a marketplace not to be in compliance with subsection 8.1(3) of the Instrument include
 - (a) the marketplace responding to orders entered by a person or company that is not a marketplace participant in that marketplace more slowly than it responds to orders by a marketplace participant in that marketplace;
 - (b) the marketplace using different technology to execute orders entered by a person or company that is not a marketplace participant in that marketplace, if that technology would not provide an equivalent service to orders entered by a marketplace participant in that marketplace; or
 - (c) the marketplace changing fees that have the effect of creating barriers to access for a person or company that is not a marketplace participant in that marketplace.
- (3) The Canadian securities regulatory authorities will not consider a marketplace to be in breach of subsection 8.1(3) of the Instrument merely because it has a different fee structure for persons or companies that are not marketplace participants in the marketplace. Instead the Canadian securities regulatory authorities will look at whether the different fee structure can be justified or whether it has only been implemented in order to create a barrier to access for those persons or companies.

PART 12 RECORDKEEPING REQUIREMENTS FOR MARKETPLACES

- ### 12.1 Recordkeeping Requirements for Marketplaces
- Part 10 of the Instrument requires a marketplace to maintain certain records. Generally, under provisions of Canadian securities legislation, the Canadian securities regulatory authorities can require a marketplace to deliver to them any of the

records required to be kept by them under securities legislation, including the records required to be maintained under Part 10.

PART 13 CAPACITY, INTEGRITY AND SECURITY OF MARKETPLACE SYSTEMS

13.1 Capacity, Integrity and Security of Marketplace Systems

- (1) Section 11.1 of the Instrument requires an ATS that exceeds the thresholds in section 11.2 of the Instrument, a recognized exchange and a recognized quotation and trade reporting system to meet certain systems, capacity, integrity and security standards.
- (2) The activities in paragraph (a) to (e) of section 11.1 of the Instrument must be carried out at least once a year. The Canadian securities regulatory authorities would expect these activities to be carried out even more frequently if there is a change to the marketplace that is material either in terms of structure or volume of trading that necessitates that these functions be carried out more frequently in order to ensure that the marketplace can appropriately service its marketplace participants.
- (3) The independent review contemplated by paragraph (f) of section 11.1 of the Instrument should be performed by competent, independent audit personnel following established audit procedures and standards.
- (4) An ATS becomes subject to section 11.1 of the Instrument after it first satisfies the volume tests in section 11.2 of the Instrument. It remains subject to section 11.1 even if, thereafter, it no longer satisfies the volume tests, unless it is successful in obtaining relief under section 12.1 of the Instrument.

National Instrument 23-101 - Trading Rules

**NATIONAL INSTRUMENT 23-101
TRADING RULES**

**NATIONAL INSTRUMENT 23-101
TRADING RULES**

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PART 1 DEFINITIONS AND INTERPRETATIONS

1.1 Definitions¹ - In this Instrument

- "approved agent" means a person or company
- (a) authorized by the securities regulatory authority to,
- (i) in the case of a recognized exchange or recognized quotation and trade reporting system, perform the functions referred to in subsection 7.1(2), or
- (ii) in the case of an ATS, perform the functions referred to in subsection 7.1(3), and
- (b) that has entered into an agreement to coordinate the performance of such functions with all other persons and companies similarly authorized or permitted;
- "best bid" means the highest price of an order to buy a particular security;
- "best offer" means the lowest price of an order to sell a particular security;
- "consolidated market display" means the information required to be displayed by the data consolidator under Part 7 of NI 21-101;
- "foreign non-reporting issuer" means an issuer
- (a) that is not incorporated under the laws of Canada or a jurisdiction,
- (b) that is not a reporting issuer, and
- (c) whose securities trade on a marketplace in Canada;

¹ A national definition instrument has been adopted as National Instrument 14-101 Definitions. It contains definitions of certain terms used in more than one national instrument. National Instrument 14-101 also provides that a term used in a national instrument and defined in the statute relating to securities of the applicable jurisdiction, the definition of which is not restricted to a specific portion of the statute, will have the meaning in that jurisdiction given to it in that statute, unless the context otherwise requires. National Instrument 14-101 also provides that a provision or a reference within a provision in a national instrument that specifically refers by name to one or more jurisdictions, other than the local jurisdiction, shall not have any effect in the local jurisdiction, unless otherwise stated in the National Instrument.

"NI 21-101" means National Instrument 21-101 Marketplace Operation;

"principal transaction" means a transaction through the facilities of a marketplace whereby a marketplace participant, as principal,

(a) purchases securities from its customer, or

(b) sells securities to its customer; and

"short sale" means a sale of a security that the seller does not beneficially own.

1.2 Interpretation - NI 21-101 - Terms defined or interpreted in NI 21-101 and used in this Instrument have the respective meanings ascribed to them in NI 21-101.

1.3 Interpretation - For the purpose of the definition of short sale in section 1.1, a seller is considered

(a) to beneficially own a security if the seller has legal authority to sell the security; and

(b) not to beneficially own a security if the seller has borrowed the security.

PART 2 MANIPULATION AND FRAUD

2.1 Price Manipulation, Deceptive Trading and Fraud

(1) A person or company shall not, directly or indirectly, engage in, or participate in any transaction or series of transactions, or method of trading relating to a trade in or acquisition of a security, if the person or company knows, or ought reasonably to know, that the transaction or series of transactions, or method of trading

(a) results in or contributes to a misleading appearance of trading activity in, or an artificial price for, a security; or

(b) perpetrates a fraud on any person or company.

(2) Despite subsection (1), in Alberta, British Columbia, Quebec and Saskatchewan, the provisions of the *Securities Act* (Alberta), the *Securities Act* (British Columbia), the *Securities Act* (Quebec) and *The Securities Act, 1988* (Saskatchewan), respectively, relating to manipulation and fraud apply.

2.2 Attempted Manipulation - A person or company shall not, directly or indirectly, engage in or participate in any transaction or series of transactions, or method of trading relating to a trade in or acquisition of a security, in an attempt to

(a) create a misleading appearance of trading activity in, or an artificial price for, a security; or

(b) perpetrate a fraud on any person or company.

2.3 Capping and Pegging

(1) A person or company that has sold a put option shall not, while that option remains unexercised, place an offer to purchase securities of the same class of securities as those underlying the option at a price higher than the last price at which the underlying security traded.

(2) A person or company that has sold a call option shall not, while that option remains unexercised, place an offer to sell securities of the same class of securities as those underlying the option at a price lower than the last price at which the underlying security traded.

PART 3 SHORT SELLING

3.1 Short Selling

(1) A person or company shall not make a short sale of a security through the facilities of a marketplace

(a) below the price at which the last sale of a board lot was displayed by the market consolidator; or

(b) at the price at which the last sale of a board lot was displayed by the market consolidator unless the last sale price was higher than the previous sale price of a board lot.

(2) Subsection (1) does not apply to the sale of a security if

(a) the seller has purchased or has entered into an unconditional contract, binding on both parties, to purchase the security, but has not yet received it;

(b) the seller beneficially owns a security convertible into or exchangeable for the security and has tendered the security for conversion or exchange or has issued irrevocable instructions to convert or exchange the security;

(c) the seller has a written option to purchase or acquire the security and has exercised the option; or

(d) the seller is making a sale of the security for an arbitrage account, if the seller knows

or has reasonable grounds to believe that an offer enabling the seller to cover the sale is then available to the seller and the seller accepts the offer immediately.

that issuer before the material fact or material change has been generally disclosed.

PART 4 FRONT RUNNING AND INSIDER TRADING

4.1 Front Running

- (1) A marketplace participant shall not as principal or agent purchase or sell on a marketplace securities of a particular class or a derivative of those securities with knowledge of an order for the purchase or sale of securities of that class or a derivative of those securities, or knowledge of a potential purchase or sale of securities of that class or a derivative of those securities, if that information has not been generally disclosed.
- (2) A marketplace participant shall not inform, other than in the necessary course of business, another person or company of an order for the purchase or sale of securities or of the potential purchase or sale of securities on a marketplace, if that information has not been generally disclosed.
- (3) A marketplace participant shall not
 - (a) purchase or sell on a marketplace securities of an issuer or a derivative of those securities in advance of the general disclosure of a report prepared by a person or company relating to those securities or the issuer of those securities, if the marketplace participant has knowledge of the report and the report can reasonably be expected to have an impact on the price of the security; or
 - (b) disclose, other than in the necessary course of business, the forthcoming disclosure of a report referred to in paragraph (a) to any other person or company.

4.2 Insider Trading of Securities of Foreign Non-Reporting Issuer

- (1) A person or company in a special relationship with a foreign non-reporting issuer shall not purchase or sell on a marketplace in Canada securities of that issuer with the knowledge of a material fact or material change with respect to that issuer that has not been generally disclosed.
- (2) A person or company in a special relationship with a foreign non-reporting issuer shall not inform, other than in the necessary course of business, another person or company of a material fact or material change with respect to

- (3) A person or company that proposes to make a take-over bid for securities of a foreign non-reporting issuer, or to become a party to a reorganization, amalgamation, merger, arrangement or similar business combination with a foreign non-reporting issuer or to acquire a substantial portion of its property shall not inform another person or company of a material fact or material change with respect to that issuer before the material fact or material change has been generally disclosed, except where the information is given in the necessary course of business to effect the take-over bid, business combination or acquisition.
- (4) For the purposes of this section, a person or company in a special relationship with a foreign non-reporting issuer means,
 - (a) a person or company that is an insider, affiliated entity or associate of,
 - (i) that issuer,
 - (ii) a person or company that is proposing to make a take-over bid for the securities of that issuer, or
 - (iii) a person or company that is proposing to become a party to a reorganization, amalgamation, merger or arrangement or similar business combination with that issuer or to acquire a substantial portion of its property;
 - (b) a person or company that is engaging in or proposes to engage in any business or professional activity with or on behalf of that issuer or with or on behalf of a person or company described in subclause (a)(ii) or (iii);
 - (c) a person who is a director, officer or employee of that issuer or of a person or company described in subclause (a)(ii) or (iii) or clause (b);
 - (d) a person or company that learned of the material fact or material change with respect to that issuer while the person or company was a person or company described in clause (a), (b) or (c); and
 - (e) a person or company that learns of a material fact or a material change with respect to that issuer from any other person or company described in this subsection, including a person or company described in this clause, and knows or ought reasonably to have known that the other person or

company is a person or company in such a relationship.

- (5) For the purposes of subsection (1), a security of the foreign non-reporting issuer includes
- (a) a put, call, option or other right or obligation to purchase or sell securities of the issuer; or
 - (b) a security, the market price of which varies materially with the market price of the securities of the issuer.

4.3 Defences

- (1) A person or company does not contravene section 4.1 or 4.2
- (a) if the person or company reasonably believed that the information in the case of section 4.1, or the material fact or material change, in the case of section 4.2 had been generally disclosed; or
 - (b) if the person or company reasonably believed that the other party to the purchase or sale of the securities or the person or company informed of the information in the case of section 4.1, or the material fact or material change, in the case of section 4.2, as the case may be, had knowledge of the information or the material fact or material change.
- (2) A person or company does not contravene subsection 4.1(1), paragraph 4.1(3)(a) or subsection 4.2(1)
- (a) if the purchase or sale was entered into as agent of another person or company under a specific unsolicited order from that other person or company to purchase or sell;
 - (b) if the purchase or sale was made under participation in an automatic dividend reinvestment plan, share purchase plan or other similar automatic plan that was entered into by the person or company before the acquisition of knowledge of the material fact or material change;
 - (c) if the purchase or sale was made to fulfil a legally binding obligation entered into by the person or company before the acquisition of knowledge of the information in the case of section 4.1, or the material fact or material change, in the case of section 4.2; or
 - (d) if

- (i) no director, officer, partner, employee or agent of the person or company who made or participated in making the decision to purchase or sell the securities had actual knowledge of the information in the case of section 4.1, or the material fact or material change, in the case of section 4.2, and
- (ii) no advice was given with respect to the purchase or sale of the securities to the director, officer, partner, employee or agent of the person or company who made or participated in making the securities by a director, partner, officer, employee or agent of the person or company who had actual knowledge of the information in the case of section 4.1, or the material fact or material change, in the case of section 4.2.

- (3) A person or company does not contravene sections 4.1 and 4.2, if the person or company purchases or sells securities of a foreign non-reporting issuer as agent or trustee for a person or company who does not contravene section 4.1 or section 4.2 by reason of paragraph 4.3(2)(b) or (c).

PART 5 BEST EXECUTION

5.1 Best Execution

- (1) A marketplace participant acting as agent for a customer shall make reasonable efforts to ensure that the customer receives the best execution price on a purchase or sale of securities by the customer.
- (2) Without limiting the generality of subsection (1), a marketplace participant acting as agent for a customer shall not execute a transaction on a marketplace that could be filled at a better price on another marketplace displayed in the consolidated market display.
- (3) In order to satisfy the requirement in subsection (1), a marketplace participant shall make reasonable efforts to use facilities providing information or ability to execute orders.

PART 6 PRINCIPAL TRADING AND OFFSETTING ORDERS

6.1 Principal Trading and Offsetting Orders

- (1) A marketplace participant, acting as agent or principal, having offsetting orders to buy and sell the same security in a marketplace at the same price shall not execute the trade for any quantity

at a price equal to the best bid or best offer displayed in the consolidated market display unless the marketplace participant first satisfies any bids or offers displayed in the consolidated market display at or better than the execution price.

- (2) A marketplace participant that receives an order to buy or sell 10,000 shares or less of a security traded on a marketplace shall not execute a principal transaction for those securities unless the marketplace participant buys at a higher price or sells at a lower price than the best bid or best offer displayed in the consolidated market.

PART 7 MONITORING AND ENFORCEMENT

7.1 Monitoring and Enforcement

- (1) A recognized exchange and a recognized quotation and trade reporting system shall set requirements that
 - (a) prohibit marketplace participants from engaging in any of the conduct prohibited under this Instrument; and
 - (b) require marketplace participants to act in accordance with subsections 5.1(1) and (3).
- (2) A recognized exchange and a recognized quotation and trade reporting system shall monitor and enforce compliance with this Instrument either
 - (a) directly if it has been approved to do so by a Canadian securities regulatory authority; or
 - (b) through an approved agent.
- (3) An ATS shall enter into an agreement with an approved agent to monitor and enforce compliance with the requirements of this Instrument.

PART 8 EXEMPTION

8.1 Exemption

- (1) The regulator or the securities regulatory authority may grant an exemption from this Instrument, in whole or in part, subject to such conditions or restrictions as may be imposed in the exemption.
- (2) Despite subsection (1), in Ontario, only the regulator may grant such an exemption.

Companion Policy 23-101CP - Trading Rules

**COMPANION POLICY 23-101CP
TO NATIONAL INSTRUMENT 23-101
TRADING RULES**

**COMPANION POLICY 23-101CP
TO NATIONAL INSTRUMENT 23-101
TRADING RULES**

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PART 1 INTRODUCTION

- 1.1 Introduction** - The purpose of this Companion Policy is to state the views of the Canadian securities regulatory authorities on various matters related to National Instrument 23-101 Trading Rules (the "Instrument"), including
- (a) a discussion of the general approach taken by the Canadian securities regulatory authorities in, and the general regulatory purpose for, the Instrument; and
 - (b) the interpretation of various terms and provisions in the Instrument.
- 1.2 Just and Equitable Principles of Trade** - While the Instrument deals with specific trading practices, as a general matter the Canadian securities regulatory authorities expect marketplace participants to transact business openly and fairly, and in accordance with just and equitable principles of trade.

PART 2 MANIPULATION AND FRAUD

2.1 Manipulation and Fraud

- (1) Subsection 2.1(1) of the Instrument prohibits the practices of price manipulation and deceptive trading, as these may create misleading price and trade activity that are detrimental to investors and to the integrity of the market. Price manipulation is a practice in which the price of a security is purposely manipulated up or down over time to benefit a position in the same or a related security. Deceptive trading activity occurs when trades occur, which do not represent a true transfer of ownership of the security and/or are intended to give a misleading appearance of activity.
- (2) Subsection 2.1(2) of the Instrument provides that despite subsection 2.1(1) of the Instrument, the provisions of the *Securities Act* (Alberta), the *Securities Act* (British Columbia), the *Securities Act* (Quebec) and *The Securities Act, 1988* (Saskatchewan), respectively, relating to manipulation and fraud apply in Alberta, British Columbia, Quebec and Saskatchewan. This is because those jurisdictions have comparable provisions to subsection 2.1(1) of the Instrument in their legislation.
- (3) Sections 2.1 and 2.2 apply to any instrument that comes within the definition of security in

securities legislation, including non-exchange traded commodity futures contracts or options.

(4) For the purposes of subsection 2.1(1) and section 2.2 of the Instrument, and without limiting the generality of those provisions, the Canadian securities regulatory authorities, depending on the circumstances, would normally consider the following activities of a person or company to result in, contribute to or create a misleading appearance of trading activity in, or an artificial price for, a security:

1. Executing any transaction in a security, if the transaction does not involve a change in beneficial ownership. This includes activities such as wash-trading or pre-arranged trades executed in order to give an impression of active trading.
2. Effecting, alone or with others, a transaction or series of transactions with the intent to induce others to purchase or sell any security.
3. Effecting, alone or with others, a transaction or series of transactions, including entering one or more orders for the purchase or sale of a security, that has the effect of artificially raising, lowering or maintaining the price of the security. This includes placing buy or sell orders, or both, to change the price of the securities in an attempt to increase the value of a position (high sale-ing) or to raise the price to attract other trades for the securities, thereby creating demand for the securities that the person or company carrying out the manipulation can satisfy by selling his, her, or its securities.
4. Entering one or more orders that could reasonably be expected to create an artificial appearance of investor participation in the market.
5. Executing a prearranged transaction in a security that has the effect of creating a misleading appearance of active public trading or that has the effect of improperly excluding other marketplace participants from the transaction.
6. Effecting, alone or with others, one or more transactions if the purpose of the transaction or transactions is to defer payment for the security traded.
7. Entering an order to purchase or sell a security, except for a security sold short in a manner not prohibited by securities legislation or the rules of the marketplace

through which the order is entered, without the ability and the intention to

- (a) make the payments necessary to properly settle the transaction, in the case of a purchase; or
- (b) deliver the security necessary to properly settle the transaction, in the case of a sale.

This includes activities known as kiting or debit kiting, in which a person or company avoids having to make payment or deliver securities to settle a trade.

8. Engaging, alone or with others, in any transaction, practice or scheme that unduly interferes with the normal forces of demand for or supply of a security or that artificially restricts or reduces the public float of a security in a way that could reasonably be expected to result in an artificial price for the security.

- (5) The Canadian securities regulatory authorities do not consider market stabilization activities carried out in connection with a distribution to be activities in breach of subsection 2.1(1) and section 2.2 of the Instrument, if the market stabilization activities are carried out in compliance with the rules of the marketplace on which the securities trade or with provisions of securities legislation that permit market stabilization by a person or company in connection with a distribution.
- (6) Sections 2.1 and 2.2 of the Instrument apply to transactions both on and off a marketplace. In determining whether a transaction results in, contributes to or creates a misleading appearance of trading activity in, or an artificial price for a security, it may be relevant whether the transaction takes place on or off a marketplace. For example, a transfer of securities to a holding company for *bona fide* purposes that takes place off a marketplace would not normally violate sections 2.1 or 2.2 even though it is a transfer with no change in beneficial ownership.
- (7) Subsections (1) and (2) of section 2.3 of the Instrument prohibit certain transactions commonly referred to as "capping and pegging". Capping and pegging typically occurs in a situation where a person or company has written an option, which obliges the person or company to sell to, in the case of a call option, or buy from, in the case of a put option, the option holder a specified number or amount of securities at a specified price. The person or company that has written the option then trades in the securities covered by the option in order

to affect their price in a direction that will make the option unprofitable to exercise. Options markets typically monitor transactions in underlying securities near expiration of the option contracts. This monitoring include securities trading activity by options specialists, market makers and member firms carrying large options positions.

PART 3 SHORT SELLING

- 3.1 Short Selling** - Subsection 3.1(1) of the Instrument refers to what is known as a "zero-plus tick" rule, *i.e.*, a short sale may be made at a price higher than the last sale price or at the same price as the last sale price if that last sale price was higher than the last differently priced trade.

PART 4 FRONT RUNNING AND INSIDER TRADING

4.1 Front Running and Insider Trading

- (1) Subsection (1) of section 4.1 of the Instrument prohibits a marketplace participant from purchasing or selling securities on a marketplace in advance of an order for those securities. Subsection (3) contains a similar prohibition with respect to reports relating to an issuer or its securities. This is commonly known as "front running".
- (2) Subsection (2) of section 4.1 of the Instrument prohibits a marketplace participant from informing, other than in the necessary course of business, another person or company of an order for securities or the potential purchase or sale of securities on a marketplace, if that information has not been generally disclosed. Paragraph (b) of subsection 4.1(3) contains a similar prohibition with respect to research reports. This is known as "tipping".
- (3) Subsections (1) and (2) of section 4.2 of the Instrument prohibit a person or company from trading with knowledge of an undisclosed material fact or material change with respect to a foreign non-reporting issuer or tipping another person or company as to such information. While Canadian securities legislation in most jurisdictions and corporate legislation in some jurisdictions also prohibit insider trading and tipping, they do so with respect to reporting issuers and generally with respect to non-reporting issuers incorporated under the applicable corporate legislation. Subsections (1) and (2) of section 4.2 of the Instrument only apply if the issuer is not incorporated under the laws of Canada or a jurisdiction and is not a reporting issuer. These subsections are now

necessary because an ATS may trade foreign securities.

- (4) Section 4.3 of the Instrument contains defences to the prohibitions in sections 4.1 and 4.2 of the Instrument. One of the factors the Canadian securities regulatory authorities will look at in determining whether the person or company had actual knowledge for the purposes of subparagraph 4.3(2)(d) of the Instrument is whether and to what extent the person or company has implemented and maintained reasonable policies and procedures to prevent contraventions of sections 4.1 and 4.2 of the Instrument by persons making or influencing investment decisions on its behalf and to prevent transmission of information contrary to sections 4.1 and 4.2 of the Instrument. These policies and procedures are commonly known as a "Chinese Wall".

PART 5 BEST EXECUTION

5.1 Best Execution

- (1) Subsection 5.1(1) of the Instrument requires a marketplace participant acting as agent for a customer to make reasonable efforts to ensure that the customer receives the best execution price on a purchase or sale of securities by the customer. The Canadian securities regulatory authorities are of the view that in making reasonable efforts, a marketplace participant should also consider whether it would be appropriate in the particular circumstances to look at markets outside of Canada.
- (2) Subsection 5.1(2) of the Instrument prohibits a marketplace participant in any marketplace from "trading through" a better priced order on another marketplace. In an environment where there are multiple competing marketplaces, it is important that all investors have access to the best price for their orders at time of execution. Without consolidation of these markets, fragmentation would occur if investors are not given information about the best price available nor are they able to access the best price. In order to mitigate possible negative effects of fragmenting the markets, it is critical for these markets to be integrated and to prevent trading through a better price existing in another marketplace.
- (3) The Canadian securities regulatory authorities are of the view that in satisfying its fiduciary obligations to its customer, a marketplace participant, depending on market conditions existing at the time, should make reasonable efforts to obtain a lower price on an order to buy or a higher price on an order to sell than is currently available in the consolidated market

display by posting a better bid or offer. In order to achieve this price improvement for a customer, the marketplace participant should have an order management system that has the capability of providing price improvement.

PART 6 PRINCIPAL TRADING AND OFFSETTING ORDERS

6.1 Principal Trading and Offsetting Orders

- (1) Subsection 6.1(1) of the Instrument ensures that any existing bids or offers in the market are satisfied when a cross occurs. The Canadian securities regulatory authorities consider a cross to be an offsetting order to buy and sell entered by a marketplace participant as principal or agent in any marketplace.
- (2) Subsection 6.1(2) of the Instrument prohibits principal transactions by a marketplace participant for orders of 10,000 shares or less of a security unless the marketplace participant buys at a higher price or sells at a lower price than the best bid or best offer displayed in the consolidated market. Principal transactions should be made as market conditions warrant and the Canadian securities regulatory authorities would expect that principal transactions not be made unless the marketplace participant is confident that the principal transaction achieves best price execution for the customer's order.

PART 7 MONITORING AND ENFORCEMENT

- 7.1 Monitoring and Enforcement** - Subsection 7.1(2) of the Instrument provides that a recognized exchange and a recognized quotation and trade reporting system may monitor and enforce compliance with the Instrument directly if it has been approved to do so by the Canadian securities regulatory authorities. At this time, all exchanges in Canada have been approved for this purpose.

Ontario Securities Commission Rule 23-501 - Designation as Market Participant

**ONTARIO SECURITIES COMMISSION RULE
RULE 23-501
DESIGNATION AS MARKET PARTICIPANT**

- 1.1 Recognized Quotation and Trade Reporting System** - A recognized quotation and trade reporting system is designated as a market participant for the purposes of the Act.

Discussion Paper - “Consolidation Plan for a Consolidated Canadian Market”

Discussion Paper:

Consolidation Plan for a Consolidated Canadian Market

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I. Executive Summary

Alternative Trading Systems ('ATSs') are electronic marketplaces which offer participants access to new types of markets, based on technology. In order to take advantage of the features and services offered by these new marketplaces, it is necessary to establish a framework which will combine them with traditional market structures and preserve the benefits of a strong centralized market system.

This discussion paper sets forth a plan for consolidating traditional marketplaces (like exchanges) with these new marketplaces to provide a consolidated Canadian market. The plan provides for the collection, consolidation and dissemination of quote and trade information. Further, it proposes to integrate all markets in order that buyers and sellers have access to the best price available at time of execution.

All marketplaces would be required to provide quotation information regarding displayed orders and transaction information for all securities traded in their system to a Data Consolidator. The Data Consolidator will be a third party facilitator, chosen by the Canadian Securities Administrators ('CSA') as a result of a Request For Proposal (RFP). The Data Consolidator will distribute a consolidated data feed for all markets.

Market Integration provides the facility for any buyer or seller to access the best priced order in any marketplace. The plan proposes that market integration be achieved in a staged implementation. Phase 1 would require that each ATS establish a link to the principal market of the securities traded by the ATS. For a listed security, the principal market will include any exchange on which that security is listed. Phase 2 will require that all ATSs and all exchanges be linked through a Market Integrator. The Market Integrator may be chosen through an RFP process initiated by the CSA; this function could be provided by an existing exchange, an ATS, the Data Consolidator or another third party.

After the ATS Proposal is finalized, Data Consolidation and Phase 1 Market Integration is expected to be in place during mid-year 2000 while timing for Phase 2 integration would be determined at a later date. The Consolidation Plan sets the framework for establishing a centralized market structure which combines the positive benefits of these new alternative trading systems with traditional auction markets.

II. The Consolidated Market

A. Background

Over the past decade, advances in technology have had a significant impact on the trade execution process in the securities industry. Specifically, non-exchange electronic trading systems, currently referred to as ATSS, have offered features and services not typically provided by traditional exchange systems or dealers. The rapid growth of these alternative systems indicate that market participants welcome the opportunity to access new competitive liquidity pools¹.

The purpose of the ATS proposal is to provide a flexible framework that facilitates the establishment of competitive systems while still providing the advantages and benefits of a centralized market.

In Canada, although we do have a Consolidated Canadian Data Feed,² the electronic linking of exchanges has not been established to provide best execution for interlisted securities. To date, ATSS trading Canadian listed securities have been allowed to operate only as members of exchanges, primarily as a result of concerns over market fragmentation. In order to provide a flexible environment that will accommodate both traditional market structures and take advantage of the benefits offered by new technologies, it is necessary to establish a plan for a consolidated Canadian marketplace.

B. Purpose and Objectives

The purpose of developing a plan to consolidate ATSS and other markets (the 'Consolidation

Plan') is to provide an environment in which all markets can operate and to combine the positive benefits of competing systems while preserving the benefits of a centralized auction market.

The consolidation function consists of two principal components: data consolidation and market integration for order routing between markets. This Consolidation Plan provides for the collection, consolidation and dissemination of quotation and transaction information for all marketplaces and for the interlinkage of those marketplaces so that all buyers and sellers of a security have access to the best price for execution.

The objectives of the Consolidation Plan are:

1. To maintain the benefits of a centralized auction market.
2. To create this centralized market while requiring a minimum of superstructure to support it.
3. To enable all market participants to have full and complete access to market information.
4. To enable all market participants to have equal access to the best price available in the market.

C. Participants

The participants in the Consolidation Plan will include all marketplaces as defined in National Instrument 21-101, i.e., all exchanges and quotation and trade reporting systems recognized in the jurisdiction of the CSA and any Alternative Trading Systems, who are registered as dealers complying with National Instrument 21-101.

¹ In the United States, ATSS now account for over thirty percent of orders in NASDAQ listed securities and close to eight percent of orders in exchange listed securities. Until recently, ATSS have operated markets which were largely outside the National Market System ('NMS'). The National Market System in the US was established over 20 years ago at the direction of the Securities and Exchange Commission. Its primary objective was to provide for 'equally regulated, individual markets which are linked together to make their best prices publicly known and accessible.' Recent rule changes adopted by the SEC have modified the regulatory framework in order to better incorporate ATSS into the NMS.

² The Consolidated Canadian Data Feed (known as the CCDF) is operated by the CEG, Canadian Exchange Group, and provides a consolidated data feed of trade and quote information for the Toronto, Montreal, Vancouver, Winnipeg and Alberta exchanges, as well as CDN.

III. Data Consolidation

Data consolidation ensures that all participants in the market have access to full and complete information regarding the securities that they wish to trade. It includes two primary types of information: pre-trade and post-trade.

Pre-trade information includes the total volume bid/offered at each price level for all committed, disclosed orders in all participating systems.

Post-trade information provides summary data for all transactions which have been executed on a security on any participating system.

Trade details include volume, price, time and system in which the trade took place.

A. Requirements for All Marketplaces

1. Quote Information

Each marketplace will be required to transmit to the Data Consolidator one or more data feeds containing quotation information and transaction information for all securities traded in its system.

Quotation information shall include:

- the symbol of the security
- the total volume bid/offered at the best five price levels for the security

The quotation information provided for the consolidated display will not provide any specific order information such as the number of buyers or sellers or the identity of any buyer or seller. Each participating system will continue to be able to provide complete and detailed information about its order book to its own participants, in accordance with the features and specifications of its own system.

Marketplaces will be required to provide quotation information only for orders that are disclosed on their system. Systems which offer a feature to allow orders to have a reserve or undisclosed volume will not be required to display the reserve or undisclosed portion of the order. In other words, to the extent that a system discloses an order in its own system, it must also disclose the same order (or portion of order) in the Consolidated Market. ATs will thus be able to preserve the competitive features inherent in their systems and to offer the benefits of selective anonymity to their own participants.

2. Executed Transaction Information

Transaction information will include for each transaction:

- the symbol of the eligible security
- the volume traded
- the price of the trade
- the time of the trade (accurate to seconds - e.g. 10:26:02)
- the system on which it was traded
- applicable trade markers such as late trade, special terms, etc.

3. Timeliness and Accuracy

Marketplaces will be responsible for providing data to the Data Consolidator in an accurate and timely manner.³ In the event of a system problem in any participant system, any trades executed that cannot be reported until after resumption of operation will be marked as 'late'.

The distribution of the consolidated data feed will not alter the rights and abilities of each marketplace to enter into agreements with subscribers for the sale and distribution of proprietary data relating to securities traded in each system's market.

B. The Data Consolidator

The Data Consolidator will receive and collect quotation and transaction information from each marketplace. The Data Consolidator will disseminate the consolidated information to market data vendors, news services and other customers in an accurate, timely and reliable manner.

1. Collection of Information

The Data Consolidator will receive information from each marketplace via a direct, high-speed computer-to-computer interface. The Data Consolidator will be responsible for determining the message protocol and the technical specifications of the data feed(s) sent by each system.

Pre-trade information will consist of a summary of total volume at each price for the top five levels of bids and offers. No information will be provided about the specific number of orders or the identity of the buyer or seller. This type of information is referred to as a 'Volume @ Price'⁴ display.

Post-trade information will consist of transaction details for all trades which have taken place on the marketplace. These details include volume, price, and time of the trade.

³ It is expected that participant systems would provide data in the manner consistent with the operation of real-time systems.

⁴ Volume @ Price is the terminology used generally to describe a display that groups all orders at a price level, indicating the total volume wanted or offered by all orders at a price level (the TSE uses the term 'Market By Price', which is a Trademark of the TSE). In Canada, the standard for Volume @ Price displays is to show the best five price levels. This matter may be further reviewed by the Governing Committee (see discussion of Governing Committee, Section III.B.6, Administration of the Data Consolidator).

2. Dissemination of Information

The Data Consolidator will disseminate a Consolidated Market by Price Feed to its customers including data vendors, news services, and other information services. The Data Consolidator will be entitled to enter into agreements with customers for the dissemination of quotation and transaction information according to a fee schedule set by the Governing Committee⁵. A fee schedule, determined by the Governing Committee, will provide for reimbursement of data fees to each marketplace. The Data Consolidator will disseminate all information provided by the participant systems.

Each marketplace will retain the right to sell and distribute its own data feeds for information on securities in its own marketplace.

The Data Consolidator will disseminate the following information:

1. the full list of securities traded by each marketplace.
2. the total volume bid/offered at each of the best five price levels for each security traded for each marketplace.
3. all transactions that have taken place on securities reported by all marketplaces. Trade reports will include symbol, price of trade, market of execution and any appropriate trade markers such as late, correction, etc.
4. at the end of each trading day on the primary market, a closing price and closing bid/ask for each security.
5. all messages sent by the principal market related to stock status (pre-opening, open, halted) will be distributed by the Data Consolidator to its subscribers.

The Data Consolidator will be responsible for all administrative functions associated with the dissemination of data including record-keeping, billing, contracts and financial reporting.

3. Currency

The data collected and disseminated for all securities which are listed, quoted or approved by marketplaces in Canada, and which trade in Canadian dollars, will be shown in Canadian

dollars by the Data Consolidator.⁶ All quote and trade prices provided to the Data Consolidator must reflect prices maintained in a Canadian dollar book, not merely be converted prices from a US\$ book. More importantly, they cannot be prices which are already quoted and represented in another foreign system such as the National Market System ('NMS') in the US.

This will mean that US systems who wish to trade Canadian listed securities for Canadian clients will quote and trade orders as part of the Canadian consolidated market. US systems who wish to operate in Canada will be required to maintain a separate Canadian book for securities listed, quoted or approved by recognized exchanges (including CDN) and to display these books in the Canadian consolidated market displays.

4. Data Display

The Data Consolidator will produce a data feed for vendors and other customers that will provide the information required for a consolidated "Volume @ Price" display, a consolidated tape, and a consolidated Previous Trades display. Vendors may also choose to develop a consolidated Time and Sales display.

Sample 'Volume @ Price' Display:

EXCH	6000 * 21.45	21.50 * 10000	ATS2
ATS1	4000 * 21.40	21.55 * 3000	EXCH
EXCH	3000 * 21.40	21.55 * 2000	ATS1
ATS2	1500 * 21.40	21.60 * 5000	EXCH
EXCH	4000 * 21.35	21.65 * 6000	EXCH

Note: Bids are shown in descending order (best bid at top) on the left side of the display; offers are shown on the right side of the display in ascending order (best offer at top). Each side shows the marketplace and the total volume bid/offered at each price level.

Sample Previous Trades Display:

EXCH	5000	21.45	11:15
ATS1	2000	21.50	11:05
ATS3	5000	21.45	11:02

⁵ The Governing Committee is discussed in further detail in Section III.B.6, Administration of the Data Consolidator.

⁶ Some securities listed in Canada trade in US dollars. These securities may be displayed in US dollars by the Data Consolidator.

EXCH	2500	21.50	11:00
EXCH	1000	21.45	10:48

Note: Trades executed in all systems would show in reverse chronological order, (most recent first) indicating the marketplace in which the trade was executed, and the volume, price and time of the trade.

No information will be provided to or displayed by vendors relating to the identity of participants in any marketplace. Specifically, pre-trade information will show only the amount of the security that is bid/offered at each price level by a system; information will not be displayed regarding either the number of orders on the bid/offer, nor the identity of the buyer or seller. Similarly, in post-trade information displays, only the identity of the system on which the trade took place will be provided, not the identity of either the buyer or seller.⁷ Individual marketplaces may choose their own policy regarding information shown to their own participants so that additional proprietary information will provide value to members of that particular system.

5. Operations

The Data Consolidator will be in operation on each day on which trading takes place on the principal market for a security. Quotation and transaction information will be collected and disseminated during the regular operating hours of the principal market (approximately 8 a.m. to 6 p.m. EST) In addition, the Data Consolidator will collect and disseminate quotation information and transaction reports at any time when another marketplace is open for trading.

During any regulatory halts on any security, it is suggested that ATSS be prohibited from trading. In the event of a regulatory halt, the Data Consolidator would then cease to disseminate information on that security until the halt has been lifted by the principal market and the security has entered a pre-opening period.

6. Administration of the Data Consolidator

⁷ At the present time, on exchange and vendor systems, the broker ID of the buyer and seller is shown on pre-trade information to exchange members only and on post-trade information to all subscribers. ATSS have policies regarding the display of information that vary.

The CSA will choose a third party facilitator to operate the Data Consolidator. The Data Consolidator will be supervised by a Governing Committee composed of representatives from all marketplaces and representatives appointed by the CSA including external business and technology experts. The Governing Committee will be chaired by a Chairperson appointed by the CSA and will be subject to review by the CSA.

The CSA currently expects that the Governing Committee will be responsible for oversight of matters including, but not limited to the following:

1. Implementation of the Consolidation Plan.
2. Operations of the Data Consolidator.
3. Determination of fees charged to subscribers.
4. Determination of formula used for cost-sharing and revenue-sharing.
5. Annual Reporting to the CSA.
6. Technology Specifications and Protocols.

7. Selection of the Data Consolidator

The Data Consolidator will be operated by a third party facilitator, chosen by the CSA. This Data Consolidator will be chosen from respondents to a Request For Proposal (RFP) issued by the CSA describing the functional and operational requirements for the Data Consolidator. The RFP will be publicized and distributed to all interested parties for response. Interested parties will be given 75 days to respond to the RFP. In their responses, interested parties will be asked to include detailed information about the technology that they will provide to perform the data consolidation function and the model they will use for cost recovery and revenue generation. Parties who may be perceived to have a conflict of interest will be asked to include in their response how they propose to manage any potential conflicts of interest.

The Data Consolidator will be chosen and will function as the consolidator for a period of five (5) years. The Data Consolidator's performance will be reviewed by the Governing Committee yearly and a full review of performance will be carried out by the CSA during the fifth year of the contract. Once the performance review is completed, the contract will be renewed or a new RFP issued.

IV. Market Integration

A. Staged Implementation

Market Integration means that any buyer or seller in a marketplace will have the right and the ability to access the best price offered or bid in any other marketplace, regardless of whether the buyer or seller is a participant in that system, or not. To accomplish this, each system must be able to route orders to any other marketplace's system in the consolidated market. In general, when any marketplace sends an order to another marketplace, the trade will take place on the marketplace receiving the incoming order, according to the priority rules of the receiving system.

Market integration is a complex task and raises some significant technology challenges. It is important to reward those systems that provide the best technology (assuming they also serve the best interests of the market) and not to make other systems wait for those who do not have the necessary technology. For this reason, a staged approach is preferred.

B. Phase 1: Principal Market Integration

Phase 1 integration will require any ATS who wished to operate in Canada, to establish a connection to the principal market for the securities being traded on its system. ATSs will be permitted to start operations when they have established this connection to the principal market. For listed securities, the principal market will be any of the exchanges on which the security is listed.⁸ For other securities, the principal market will be considered to be the market which has the largest trading volume for that security in Canada. Each ATS must satisfy any better priced bids or offers on the principal market before execution of a match in its system; i.e. no trade may take place on an ATS which will 'trade through' a better priced order on the principal market. Further, the principal market will also be required to satisfy a better bid/offer on any participating ATS. This approach protects any firm orders that have been entered and have established a bid or offer on the principal market.

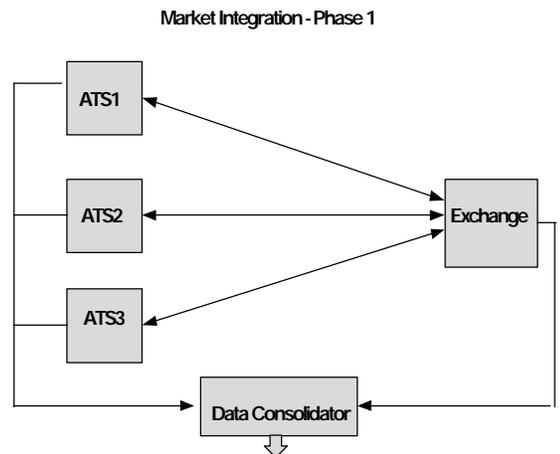
During Phase 1, integration will only be required between ATSs and the principal markets; ATSs will not be required to satisfy better bids and offers on other ATSs. While each ATS is only required to provide a connection to a principal

market, any ATS may establish connections to any other ATS that it chooses.

Example:

System 'ATS1' has a buyer for 10,000 shares of XYZ at \$10 and a seller for 10,000 shares of XYZ at \$10. There is an offering for 2000 shares of XYZ on Exchange A, which is the principal market, at \$9.95. System 'ATS1' must buy the 2000 shares offered at \$9.95 on the exchange and then match the balance of 8000 shares at \$10. The buyer in system 'ATS1' will have bought 2000 shares at \$9.95 and 8000 shares at \$10. The seller in 'ATS1' will have sold only 8000 shares at \$10, since there was a seller with a better price in the principal market.

ATS systems who wish to establish a connection to a principal market will do so using the message protocol determined by the principal market.⁹ The interconnection between ATSs and the exchange is illustrated in the diagram below titled "Market Integration - Phase 1".



C. Phase 2: Full Integration (No Trade-Throughs)

1. Order Routing requirements

Phase 2 integration will establish more complete market integration and order routing between all marketplaces in order to ensure that there will be price protection for all orders between all competing marketplaces. Each marketplace will have the responsibility to monitor the quotes in

⁸ At the time of writing, there are a number of Canadian equities which are interlisted on different markets. Should the proposed restructuring plan of the Canadian exchanges be implemented, then the Consolidation Plan will require the ATS to go to the single exchange on which a security is listed.

⁹ For listed securities, the current standard protocol used by the TSE, ME, VSE and ASE is the STAMP protocol.

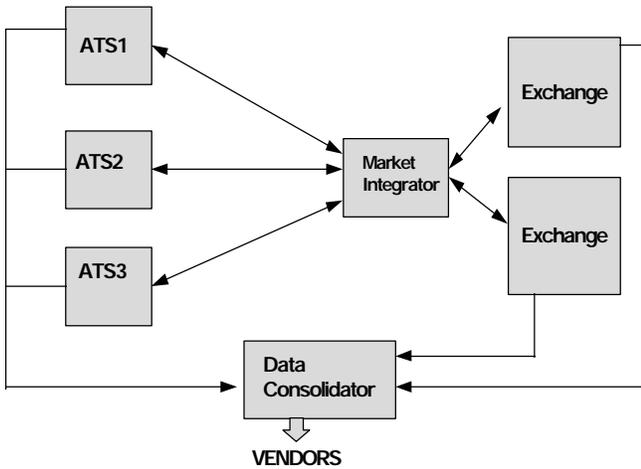
all other marketplaces and will send their orders to other systems via a direct connection or through a Market Integrator. Each system thus maintains control over its own orders and has responsibility for managing order execution.

Example:

'ATS1' gets an order to buy 10,000 shares at \$10.50. The offering in system 'ATS1' is \$10.55 for 6,000 shares. Exchange B also has an offering for 5000 shares at \$10.55 and System 'ATS2' has an offering for 4000 at \$10.50. The current bid in all three systems is \$10.45. Systems 'ATS1' will be required to send an order to 'ATS2' to buy the 4000 shares at \$10.50 and then bid for the remaining 6000 shares at \$10.50 in its own system. System 'ATS1' may send the order either via a direct connection to 'ATS2' or to the Market Integrator for routing to 'ATS2'.

The diagram shown below, entitled 'Market Integration - Phase 2', illustrates the integration between ATSS and exchanges, assuming integration is performed through a Market Integrator.

Market Integration - Phase 2



2. Selection of a Market Integrator

There are several options regarding how Phase 2 integration could be implemented. In a distributed approach, each marketplace would be required to provide a connection to all other participating systems. In a centralized approach, a single integrator/consolidator could provide the interconnection between all marketplaces. In fact, both data consolidation

and market integration could be provided by the same entity.

The distributed approach, where each marketplace connects to all other marketplaces, would result in substantial duplication of effort and multiple connections for all systems. The centralized approach, on the other hand, may mean establishing a new intermediary between marketplaces. It is important that a solution be chosen which is both technically sound and relatively easy to implement. The accepted solution will also very much depend on the number of participants in the consolidated market and the amount of activity which is generated between markets.

A recognized exchange or an ATS could provide the interlinkage between marketplaces to allow for access to better prices across all marketplaces. Each ATS would then have the choice of routing directly to another ATS or going through the central router system to access another ATS. In this way, all marketplaces would be interconnected for best price execution without having to create a new external structure for routing orders.

As with the selection of the Data Consolidator, there are several likely choices to provide this functionality. However, it is important to ensure that the best choice is made to provide the best technology solution and minimize any potential conflicts of interest. For this reason, an RFP may be issued to choose a third party facilitator to provide market integration functionality. The RFP would be publicized and distributed to all interested parties for response. Interested parties would be given approximately 75 days to respond. In their responses, interested parties should include detailed information about the technology that would be provided for market integration including technical specifications and protocols as well as expected response times, redundancy provisions, etc. Parties with a perceived conflict of interest would be required to include in their response how they propose to manage any potential conflict of interest. A Market Integrator would be chosen by the CSA from respondents to the RFP.

D. Response Times for Market Integration

When any marketplace sends an order to another system for execution, it should have a reasonable expectation that orders will be filled immediately. Systems which do not have the technology capacity to provide minimum response times will hinder the effective implementation of a consolidated market. For

that reason, there will be a time-out allowed for response times on orders.

Any marketplace should reasonably expect to receive a response (a fill, a cancel or no fill response) to an order in under 3 seconds. If the principal market, or any other marketplace, has not responded within 3 seconds, the system may proceed with its match without compliance with the trade-through policy. It is not reasonable to slow the trade process for systems which cannot meet standards for quick and accurate response. Systems that repeatedly get "timed out" for slow response will not benefit from market consolidation to the extent that other more technically adept systems will. In addition, systems which repeatedly are unable to meet response standards will be subject to regulatory oversight and may be subject to penalties for non-compliance.

Trade-throughs may occur inadvertently, in a small percentage of trades, due to time delays in information reaching systems about better priced orders available in the consolidated market. It will be up to the parties performing market surveillance to examine message logs to determine that the better price had been established just prior to the trade through and that the system initiating the trade had not received the update prior to effecting their trade. Cross referencing of trade times, with published quote time, should be automated by the Data Consolidator; a grace period of up to 3 seconds may be allowed for any trades which had caused a trade-through to occur.

E. Clearing and Settlement

Each ATS system will be required to be a member of an exchange or to register as a dealer and be a member of an SRO, other than an exchange. An ATS that chooses not to be a member of an exchange, but is a member of the IDA, will have access to CDS and CDCC for clearing and settlement purposes. Reporting of trades done by ATSS to CDS could be done either directly by the ATS or through the Data Consolidator in a manner similar to the reporting currently done by each exchange for exchange trades. Each ATS will be responsible for delivery of information regarding trade details to its own service bureau providing clearing services with details relative to settlement instructions for their clients.

It is recommended that all marketplaces work with CDS and the appropriate clearing service bureaus to facilitate improvements to the flow of trade information from point of entry through to settlement. This is of particular importance for Straight-Through-Processing (STP). In simplest terms, STP means that all the details required to

complete a transaction are attached to an order at the time of entry, resulting in automated processing of the complete transaction from initiation through clearing and settlement, without any participant having to re-enter trade details into multiple systems and then reconcile them. Under STP, all information required in the settlement of a trade is attached to an order at time of entry (or as soon as possible thereafter) so that, as the trade passes through each step of the trade process cycle, all of the appropriate information is passed with it. STP has several benefits, the most important of which is to reduce the requirements for reconciliation of data entered from separate systems and the associated errors resulting from transcribing of data from one system to another.

V. Summary

The preceding discussion outlines a consolidation plan to allow ATSS to operate effectively in Canada while preserving the benefits of a centralized market.

As noted earlier in this document, this paper has been prepared based on the existing exchange structure in Canada, with interlisted securities between exchanges. The CSA is currently reviewing any potential implications of the exchange restructuring proposal relative to the Consolidation Plan.

The Consolidation Plan describes consolidation of pre-trade and post-trade information and integration of marketplaces for access to best execution. This Plan sets the framework for a consolidated market structure and aims to achieve the following goals:

- 1. Maintain the benefits of a centralized auction market through a consolidated central market structure.**
- 2. Create this centralized market structure while requiring a minimum of superstructure to support it.**
- 3. Enable all market participants to have full and complete access to market information.**
- 4. Enable all market participants to have equal access to the best price available in the market.**