



ONTARIO
SECURITIES
COMMISSION

OSC Staff Notice 21-704

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Market Regulation Branch Annual Report

Table of Contents

1. Introduction

- 1.1 Role of the Market Regulation Branch
- 1.2 Focus of the Market Regulation Branch

2. Changes in Market Structure

- 2.1 Multiple marketplaces
 - A. Order protection rule
 - B. Regulation of ATs and exchanges
- 2.2 The emergence of non-transparent marketplaces and new order types
- 2.3 Use of technology in trading
 - A. Market Events of May 6
 - B. Electronic trading and direct market access

3. Clearing and Settlement

- 3.1 Mandatory recognition of clearing agencies
- 3.2 Institutional trade matching deadline





1. Introduction

1.1 Role of the Market Regulation Branch

1.2 Focus of the Market Regulation Branch

1. Introduction

This report summarizes the Market Regulation Branch's key policy activities and initiatives relating to market structure and clearing and settlement for the fiscal year ending March 31, 2010 (fiscal 2010). It also provides an update on these key initiatives for the subsequent period up to September 15, 2010.

1.1 Role of the Market Regulation Branch

The Market Regulation Branch (or we) regulates key market infrastructure entities and develops and implements policies to address market structure, trading and post-trade clearing and settlement issues.

Market infrastructure entities include marketplaces (exchanges and alternative trading systems (ATSS)), self-regulatory organizations (SROs), clearing agencies, compensation funds, information processors and matching service utilities.

These entities are required to comply with requirements that are imposed through securities legislation, or imposed by the OSC as terms and conditions of recognition, approval or exemption. The objective of our regulation and oversight is to assess compliance by these entities with statutory and other requirements. We do this by reviewing and approving their rules, conducting reviews of their operations and reviewing their reporting. We also work closely with some of them, such as SROs and other entities that play a role in the regulation of our market participants, in an effort to harmonize regulatory requirements.

1.2 Focus of the Market Regulation Branch

Over the past few years, numerous ATSS have started operating in Canada, creating a multiple marketplace environment. As part of the competitive landscape, different ATSS and exchanges now offer market participants choices with respect to facilities and trading strategies. In addition, technology plays a key role in how marketplaces offer services and how market participants conduct trading. The evolution of technology has led to an increasingly complex market. These recent developments in market structure have had an impact on retail and institutional investors, marketplaces and dealers.



At the same time, the recent financial crisis highlighted the role of other market infrastructure entities, in particular clearing agencies, in reducing the risks and uncertainties faced by market participants, and thus their systemic importance.

As the Canadian market is undergoing significant changes, a key focus for the Market Regulation Branch in fiscal 2010 included analyzing and monitoring these changes and addressing regulatory concerns. In particular, we focused on issues related to trading on multiple marketplaces and the role of technology.

As part of policy development, we frequently consult with marketplaces, dealers, vendors, investors and other market participants, and seek feedback through the public comment process. We would like to thank everyone who participated in consultations and responded to our requests for comments. We welcome further comments as we continue to work through various initiatives.





2. Changes in Market Structure

2.1 Multiple marketplaces

2.2 The emergence of non-transparent marketplaces and new order types

2.3 Use of technology in trading

2. Changes in Market Structure

The emergence of multiple marketplaces and new order types and advances in technology have increased the complexity of trading. They have had an impact on how dealers and investors trade and have highlighted the need for a greater understanding by all who trade in the market of the options available.

The Market Regulation Branch at the OSC, and in some cases together with other CSA jurisdictions and the Investment Industry Regulatory Organization of Canada (IIROC), have been monitoring changes to the Canadian market structure and have been analyzing whether these changes give rise to regulatory concerns.

In fiscal 2010, we focused on order protection, the regulation of ATs and exchanges and market structure issues relating to dark liquidity¹ and electronic trading. We have taken and will continue to take a holistic approach when reviewing market structure issues because they cannot be examined in isolation.

2.1 Multiple marketplaces

The number of equity marketplaces operating in Canada has increased from six in 2005 to 10 in 2010. We have been examining various issues relating to the emergence of multiple marketplaces, in particular:

- The need to prevent immediately accessible, visible, better-priced limit orders from being traded through; and
- The appropriateness of regulation of ATs and exchanges.

A. Order protection rule

On November 13, 2009, the Canadian Securities Administrators (CSA) introduced the Order Protection Rule (OPR) through amendments to National Instrument 21-101 *Marketplace Operation* (NI 21-101) and related Companion Policy 21-101CP, and National Instrument 23-101 *Trading Rules* and related Companion Policy 23-101CP. The OPR will come into effect on February 1, 2011.

¹ “Dark liquidity” is a term that refers generally to dark pools and dark orders. Dark pools are marketplaces that offer no pre-trade transparency. Dark orders are orders that have limited or no transparency.

Currently, the applicable provisions are found in IIROC's UMIR 5.2 *Best Price Obligation*, which only applies to dealers. The OPR will shift the obligation to marketplaces. It will require marketplaces to have policies and procedures reasonably designed to prevent trade-throughs, so that immediately accessible, visible, better-priced limit orders are executed before inferior-priced orders. CSA staff are currently working with the industry to address implementation issues.

Order protection is essential in maintaining investor confidence and fairness in the market. In a multiple marketplace environment, market participants, including retail investors, must be assured that no immediately accessible, visible, better-priced limit orders are being traded through, regardless of the marketplace where the order is entered, the sophistication of the participant or the size of the order.

For more information:

- [CSA Notice of Amendments to National Instrument 21-101 *Marketplace Operation* and National Instrument 23-101 *Trading Rules*, published on November 13, 2009](#)
- [CSA Staff Notice 23-307 *Order Protection Rule – Implementation Milestones*](#)
- [CSA Staff Notice 23-309 *Frequently Asked Questions about the Order Protection Rule and Intentionally Locked or Crossed Markets – Part 6 of National Instrument 23-101 and Related Companion Policy*](#)
- [UMIR 5.2 *Best Price Obligation*](#)

B. Regulation of ATs and exchanges

Market Regulation staff at the OSC, together with staff of the other CSA jurisdictions, continue to review the regulatory requirements for recognized exchanges and ATs to determine if they are up to date and appropriate for the current competitive landscape.

OSC staff completed the first phase of the review, which focused on transparency of filings by exchanges and ATs. In October 2009, OSC staff implemented a process that would make public, summary information about proposed changes to operations of all marketplaces. This process has since been expanded to also publish summary information about initial operations of new ATs. The summary information, both regarding proposed changes and initial operations, will be published for a 30-day comment period. OSC staff have also indicated that marketplaces are expected to publish a detailed description on their websites of how their market or facility operates and the order types available and order features or characteristics. This enables dealers

and investors alike to obtain information about the choices they face when trading in Canada's multiple marketplace environment.

The second phase of the review involves examining the requirements for exchanges and ATSS set out in NI 21-101. Because of the similarities of certain operations of exchanges and ATSS, we are considering whether any requirements should be aligned. The second phase is expected to be completed at the end of 2010 and any resulting amendments to NI 21-101 will be published for comment.

For more information:

- [OSC Staff Notice 21-703 *Transparency of the Operations of Stock Exchanges and Alternative Trading Systems*](#)

2.2 The emergence of non-transparent marketplaces and new order types

On October 2, 2009, the CSA and IIROC published Concept Paper 23-404 *Dark Pools, Dark Orders and Other Developments in Market Structure in Canada*. The paper sought feedback on a broad range of market structure issues, including dark pools, new dark order types, market pegged orders² and smart order routers (SORs)³. Click [here](#) to read the concept paper and the comments that we received. In addition, the CSA and IIROC held a forum on March 23, 2010 for market participants to discuss the issues raised in the concept paper.

The key issues raised by market participants in response to the concept paper and at the forum include:

- whether dark pools should be required to offer price improvement;
- the practice of dark pools sending indications of interest to attract order flow;
- the fairness of a marketplace using a proprietary SOR that has access to information on that marketplace that is not otherwise available to other marketplace participants; and
- the practice of broker preferencing⁴.

² Market pegged orders are orders that are priced and re-priced to a reference price such as the national best bid (offer) or a marketplace's best bid (offer). They are also referred to as reference priced orders.

³ A smart order router is a technological tool that connects to multiple marketplaces and consolidates and analyzes order information from these marketplaces. It then makes order routing decisions seeking to obtain best execution and/or best price, or facilitate the execution of the strategy determined by the user.

⁴ Broker preferencing means a marketplace feature that allows orders from the same participant or subscriber to execute ahead of other orders posted at the same price in a central limit order book.

On May 28, 2010, the CSA and IIROC published [Joint Staff Notice 23-308 Update on Forum to Discuss CSA/IIROC Joint Consultation Paper 23-404 "Dark Pools, Dark Orders and Other Developments in Market Structure in Canada" and Next Steps](#)

The notice summarizes the issues that were discussed and provides an overview of the views expressed on those issues including a summary of comments.

OSC staff, along with IIROC and other CSA staff, are currently working on a draft position paper to be published in fall 2010. It will outline our position on some of the issues identified in the concept paper and the forum relating specifically to dark pools and dark orders.

2.3 Use of technology in trading

Technology has increased the speed and complexity of trading. It has also led to easier access to marketplaces for non-dealers, either by subscribing to ATSS or by having "direct market access" (DMA) through their dealers.

Together with other CSA jurisdictions and IIROC, we continue to examine the risks associated with technology and electronic trading and, where appropriate, we will develop responses to address any regulatory concerns.

A. Market Events of May 6

The market volatility on May 6, 2010 dominated the equity market headlines, with financial markets experiencing a brief but very severe drop in prices, followed by an equally rapid recovery. Although less dramatic declines were seen in Canadian markets than in the U.S. markets, some declines were significant. The CSA and IIROC are working closely on a number of initiatives in response to the events of May 6. IIROC has also completed its analysis of the events and has published a report on its findings.

For more information:

- [Joint CSA/IIROC News Release dated May 14, 2010](#)
- [IIROC's report *Review of the Market Events of May 6, 2010*](#)

B. Electronic trading and direct market access

The CSA and IIROC have been examining issues relating to direct market access (DMA) and are developing a proposal that will address risks associated with electronic trading (such as market risk, and credit risk), DMA and other issues associated with technology. We are also examining issues related to high frequency trading, co-location and outsourcing.

For more information:

- [Joint CSA/Market Regulation Services Inc. Notice on Trade-Through Protection, Best Execution and Access to Marketplaces, dated April 20, 2007](#)
- [CSA/IIROC Joint Staff Notice 23-308 Update on Forum to Discuss CSA/IIROC Joint Consultation Paper 23-404 "Dark Pools, Dark Orders and Other Developments in Market Structure in Canada" and Next Steps](#)



3. Clearing and Settlement

3.1 Mandatory recognition of clearing agencies

3.2 Institutional trade matching deadline

3. Clearing and Settlement

3.1 Mandatory recognition of clearing agencies

As of March 1, 2011, amendments to section 21.2 of the *Securities Act* (Ontario) will prohibit clearing agencies from carrying on business in Ontario unless they are recognized as a clearing agency by the Commission. Clearing agencies operating in Ontario will, therefore, be required to apply to be recognized or exempted from the recognition requirement.

On March 19, 2010, we issued OSC Staff Notice 24-702 *Regulatory Approach to Recognition and Exemption from Recognition of Clearing Agencies*. The notice sets out the following:

- the criteria that a clearing agency is expected to meet in order to operate in Ontario,
- the application process,
- how we handle applications for recognition or exemption from the recognition requirement, and
- our approach in making recommendations to the Commission with respect to the application.

The notice also describes some scenarios where we may be prepared to recommend to the Commission that a clearing agency be exempted from the recognition requirement.

We encourage all entities operating, or intending to operate, as a clearing agency in Ontario to familiarize themselves with the new statutory requirement and to contact staff listed on OSC Staff Notice 24-702 with any questions.

For more information:

- [OSC Staff Notice 24-702 Regulatory Approach to Recognition and Exemption from Recognition of Clearing Agencies](#)

3.2 Institutional trade matching deadline

On April 16, 2010, the CSA published amendments to NI 24-101 *Institutional Trade Matching and Settlement* (NI 24-101). NI 24-101 requires dealers and advisers to establish, maintain and enforce policies and procedures to achieve matching of institutional trades by a specified deadline. The original deadline was set at midnight on the date that the trades occurred (i.e.

trade date), and NI 24-101 provided for a transition period to meet this deadline. The amendments remove the original matching deadline, and maintain the current deadline of no later than noon on the business day following the trade date (i.e. trade date + 1). The amendments became effective on July 1, 2010.

NI 24-101 came into force on April 1, 2007. Since then, CSA staff have been monitoring the industry's progress in achieving the matching deadline for institutional trades of midnight on the trade date. It became apparent that industry participants required more time to adjust their middle and back office processes to meet this matching deadline. The industry has also commented that this matching deadline is not justified from a cost-benefit perspective without a clear indication that the standard trade date + 3 settlement cycle in the North American capital markets would be shortened.

We, together with other CSA staff, continue to monitor developments in this area. In the future, the CSA may consider re-introducing the matching deadline of midnight on trade date into NI 24-101 if circumstances were to change, for example, if the standard trade date + 3 settlement cycle in global markets is shortened.

We are currently reviewing CSA Staff Notice 24-305 *Frequently Asked Questions About National Instrument 24-101 – Institutional Trade Matching and Settlement and Related Companion Policy* and will make any consequential changes necessary to reflect the amendments to NI 24-101.

For more information:

- [CSA Notice of Amendments to National Instrument 24-101 *Institutional Trade Matching and Settlement* and Companion Policy 24-101CP *Institutional Trade Matching and Settlement* dated April 16, 2010](#)
- [CSA Notice and Request for Comments on Proposed Amendments to National Instrument 24-101 *Institutional Trade Matching and Settlement* and Companion Policy 24-101CP *Institutional Trade Matching and Settlement* dated October 30, 2009](#)
- [CSA Staff Notice 24-305 *Frequently Asked Questions About National Instrument 24-101 – Institutional Trade Matching and Settlement and Related Companion Policy*](#)





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