

13.1.1 Application for Recognition of Market Regulation Services Inc.

**APPLICATION FOR RECOGNITION OF MARKET REGULATION SERVICES INC. - NOTICE AND REQUEST FOR COMMENTS**

Market Regulation Services Inc. (RS Inc.) has applied to be recognized as a self-regulatory organization (SRO) in Alberta, British Columbia, Manitoba, Ontario and Québec (the "Recognizing Regulators"). RS Inc. will operate as a regulatory services provider under the Alternative Trading System (ATS) proposal and will administer and enforce trading rules for the marketplaces that retain its services.

The Recognizing Regulators are publishing for comment the application for recognition of RS Inc. (the "Application") and the following additional related documents. These documents are attached.

1. Proposed criteria for recognition – In the Application, RS Inc. responded to each of the recognition criteria prepared by the Recognizing Regulators. Following the comment process and resolution of all outstanding issues, each Recognizing Regulator expects to issue an order recognizing RS Inc. with terms and conditions based on the recognition criteria.
2. Rules and Policies - The Universal Market Integrity Rules (UMIRs) are subject to approval by the Recognizing Regulators. The exchanges that contract with RS Inc. will adopt the UMIRs and RS Inc. will also adopt the UMIRs to govern the activities of ATSS that contract with it.
3. Oversight program - The Recognizing Regulators will establish an oversight program for RS Inc. under a Memorandum of Understanding (MOU). The MOU includes a protocol for the joint review and approval of rules, policies and other similar instruments of RS Inc., the filing of significant changes to RS Inc.'s operations, and the performance of examinations of RS Inc.'s regulation services.

**A. Background**

In July 2000, the Canadian Securities Administrators (CSA) published the Alternative Trading System (ATS) proposal without taking a position on how market regulation should be performed for the equity market. The request for comment invited industry participants to consider possible solutions. The CSA made it clear that it was willing to participate in discussions but was looking to the industry to propose alternatives for market regulation in the equity market.

In response to the market regulation aspect of the request for comment, the Toronto Stock Exchange Inc. (TSE) and the Investment Dealers Association of Canada (IDA) jointly proposed to create RS Inc. to perform market regulation for the equity market.

**B. Recognition of RS Inc.**

Staff of RS Inc. and of the Recognizing Regulators have engaged in extensive discussions leading to the publication of the recognition criteria and the Application.

There are proposed recognition criteria for each of the following areas:

1. Corporate Governance
2. Fees
3. Access
4. Financial Viability
5. Capacity to Perform Regulatory Functions
6. Capacity and Integrity of Systems
7. Purpose of Rules
8. Rules and Rule-Making
9. Financial Statements
10. Discipline Rules
11. Due Process
12. Information Sharing
13. Additional Information and Compliance with Oversight

RS Inc. must meet each of the recognition criteria to the satisfaction of the Recognizing Regulators.

**Specific areas for comment**

**We are seeking comments on all aspects of the proposed criteria for recognition and the Application.** We also request specific comment on the matters identified below and we have highlighted certain other important aspects of RS Inc.'s Application.

1. Conflicts of Interest

In the Notice published with the ATS Rules on August 17 (August 31 in Québec), the Recognizing Regulators indicated that they were examining the Application to determine if it was not contrary to the public interest to recognize RS Inc. as an SRO. Among the factors considered was "the ability of both owners of RS Inc. to avoid or manage situations of conflicts of interest relating to the self-regulatory obligations of RS Inc."

Initially, both the TSE and IDA would own 50% of RS Inc. This initial ownership structure could evolve with the addition of other marketplaces if and when they reach certain levels of Canadian equity market share. Corporate governance rules are also proposed in order to ensure the appointment of "independent directors" and other marketplaces' representatives on the initial RS Inc. Board (see Section 2 below).

Question 1:

Do the proposed ownership structure and corporate governance rules of RS Inc. avoid or adequately manage conflicts of interest related to its status as a self-regulatory organization?

2. Corporate Governance

*Calculation*

The initial RS Inc. Board will be composed of 11 directors: 5 independent directors; 5 non-independent directors and the president of RS Inc. who will be deemed to be neither independent nor non-independent. The TSE and the IDA will each appoint 2 non-independent directors. The fifth non-independent director, who will be deemed to be neither a representative of the TSE nor of the IDA, will be an individual with experience with the Canadian venture capital market appointed jointly by the TSE and the IDA. However, if CDN becomes regulated by RS Inc. and reaches or exceeds a "Market Share" of 10% of the Canadian equity securities market, CDN will be entitled to nominate the fifth non-

independent director. "Market Share" is calculated on the trading activity of the previous calendar year, based on 25% trading value, 25% trading volume and 50% number of trades. This calculation is used for various purposes in the Application. We request comment on whether the calculation for purposes of determining Market Share is appropriate.

Question 2:

Is the calculation for determining Market Share appropriate (i.e., 25% trading value, 25% trading volume and 50% number of trades)?

#### *ATS representation*

RS Inc. proposes that its board include at least one ATS representative at all times. This representative will be considered to be an independent director until such time as the ATS that such individual is associated or affiliated with becomes a marketplace regulated by RS Inc. or the individual becomes a marketplace participant. Thereafter, the representative of ATSs will be considered to be a non-independent director. RS Inc. proposes to permit each ATS that attains a 10% Market Share (as defined above) to appoint a representative to the Board.

Question 3:

Does RS Inc.'s proposal for ensuring that there is at least one ATS representative on its board at all times do so appropriately?

#### *Definition of Independent Director*

RS Inc. proposes to define "independent director" as excluding a marketplace, a marketplace participant, a shareholder of RS Inc. and an affiliated entity of any of the above. The proposal to exclude marketplace participants from the definition of "independent director" has the effect of excluding both dealer and non-dealer subscribers of an ATS. For example, individuals who are subscribers of an ATS would not be eligible to be independent directors of RS Inc. We request comment on the appropriateness of the criteria for an "independent director".

RS Inc. also proposes to include as a guideline for the selection of independent directors that its Governance Committee consider any affiliations the candidate has had with any exchange, quotation and trade reporting system or ATS in determining whether the candidate is qualified to act as an independent director.

Question 4:

Is the definition of "independent director" appropriate? Should there be a "cooling off" period before an individual who has been associated with any exchange, quotation and trade reporting system or ATS can be considered eligible to serve as an independent director of RS Inc.?

### 3. Fees

RS Inc.'s proposal states that RS Inc. will allocate the cost of regulation market-by-market. In other words, the fees for ATSs that facilitate trading in securities listed on an exchange in Canada will be based on RS Inc.'s cost of regulating that Canadian exchange and any ATSs trading that exchange's listed securities. For example, an exchange-traded security would have the same cost of regulation whether it is traded on an exchange or on an ATS. The fee model may raise issues

of cross-subsidization between the ATS and the exchange where the securities are listed and we need to ensure that the proposed fee model is not a barrier to entry for ATSs.

Question 5:

Please comment on the proposed fee model, allocating costs on a market-by-market basis and, in particular, whether it would create a barrier to entry for ATSs.

ATSs may also trade foreign securities. RS Inc. proposes that for determining fees, it will consider foreign securities not traded on a Canadian exchange as a distinct market. RS Inc. will base the fees charged to ATSs that facilitate trading in securities listed or quoted only on a foreign exchange on RS Inc.'s cost of regulating those securities. A security listed only on a foreign exchange might have a substantially different cost of regulation from a security listed on a Canadian exchange.

Question 6:

Is the fee model proposed by RS Inc. fair and reasonable with respect to allocating costs to ATSs that trade foreign securities?

In addition, the TSE will provide certain services to RS Inc. (such as information systems) based on cost plus mark-up of up to 15%. RS Inc. retained an independent consultant to review its proposed cost allocation methodology and, in general, the report concludes that RS Inc.'s overall cost allocation model is reasonable. However, RS Inc. has not yet finalized its budget. RS Inc. has agreed to provide a report on cost allocation by November 10, 2001, once it has finalized its budget.

The TSE proposes to allocate the full cost of these services to RS Inc. and add a surcharge on each allocation.

Question 7:

Please comment on whether a surcharge of up to 15% on the cost of the services the TSE will provide to RS Inc. is appropriate.

### 4. Access

RS Inc. proposes to require each marketplace that contracts with it to have systems in place that meet its requirements for surveillance and reporting. This means that marketplaces would have to provide data feeds to RS Inc. in STAMP format or in such other format (including FIX format) as may be required by RS Inc. from time to time.

Question 8:

What would be the approximate cost to an ATS of providing data in STAMP format initially? What would be an appropriate phase-in period for RS Inc. to accept data in FIX format?

RS Inc. also proposes that all marketplaces give RS Inc. staff access to their systems to implement regulatory decisions such as halting stocks, releasing stock freezes, etc.

Question 9:

Please comment on whether it is appropriate for RS Inc. to require that a marketplace give RS Inc. staff access to its systems to implement regulatory decisions.

## 5. Financial Viability

RS Inc. will be a not-for-profit organization. At start-up, the TSE and the IDA will provide RS Inc. funding through a long-term loan facility. RS Inc. proposes to repay this debt over several years and it will constitute part of the operating expenses to be recovered from marketplaces or marketplace participants. The loan will cover RS Inc.'s start-up operation costs. RS Inc. will disclose the terms of the loan facility once details have been finalized.

## 6. Capacity and Integrity of Systems

At least initially, RS Inc. intends to use the TSE's surveillance systems.

### Universal Market Integrity Rules

The CSA published the UMIRs for comment on April 20, 2001<sup>1</sup> and received approximately 25 comment letters. The UMIRs are a joint initiative of the TSE and CDNX.

Several commenters raised issues concerning the applicability of the UMIRs to marketplaces other than equity auction marketplaces (such as the TSE and CDNX). There were also comments concerning particular aspects of the rules such as the scope of authority. Staff are still in the process of assessing the comment letters received.

RS Inc. intends to adopt the UMIRs as its "market integrity" trading rules. **The Recognizing Regulators have not approved the proposed UMIRs published with this notice.** The Recognizing Regulators will be reviewing and approving the final version of the UMIRs, including any changes from the version published on April 20, 2001, in connection with the recognition of RS Inc.

### Oversight Program

We are publishing the MOU and other documents relating to the oversight program for RS Inc.

## C. Comment Process

You are asked to provide your comments in writing and to send them on or before **November 9, 2001** to all of the CSA listed below in care of the OSC, in duplicate, as indicated below:

British Columbia Securities Commission  
Alberta Securities Commission  
The Manitoba Securities Commission  
Ontario Securities Commission

c/o John Stevenson, Secretary  
Ontario Securities Commission  
20 Queen Street West  
Suite 1903, Box 55  
Toronto, Ontario M5H 3S8  
E-mail: [jstevenson@osc.gov.on.ca](mailto:jstevenson@osc.gov.on.ca)

Please also send your submission to the Commission des valeurs mobilières du Québec as follows:

Denise Brosseau, Secretary  
Commission des valeurs mobilières du Québec  
800 Victoria Square  
Stock Exchange Tower

P.O. Box 246, 22nd Floor  
Montréal, Québec H4Z 1G3  
E-mail: [denise.brosseau@cvmq.com](mailto:denise.brosseau@cvmq.com)

We request that you submit a diskette containing your submission (in DOS or Windows format, preferably WordPerfect). The confidentiality of submissions cannot be maintained because securities legislation in certain provinces requires that a summary of written comments received during the comment period be published.

Following the comment period, staff of the Recognizing Regulators will consider the comments received on the proposed criteria for recognition, the Application and the related documents. If staff of the Recognizing Regulators are satisfied that RS Inc. meets the criteria for recognition, they will recommend that their Commissions recognize RS Inc. as an SRO. Recognition will take the form of a recognition order with terms and conditions generally in the form of those attached to this notice.

If you have questions, you may contact:

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<sup>1</sup> See CSA Request for Comment 23-401.