

## CANADIAN SECURITIES ADMINISTRATORS REQUEST FOR COMMENT 23-401

Proposed Universal Market Integrity Rules of TSE RS and CDNX

The Canadian Securities Administrators (CSA) are seeking comments on the proposed Universal Market Integrity Rules (UMI rules) published concurrently by Toronto Stock Exchange Regulation Services (RS) and the Canadian Venture Exchange Inc. (CDNX). The UMI rules are a joint initiative of RS and CDNX undertaken to harmonize their market integrity rules.

In response to the CSA proposal on alternative trading systems (ATS), the Toronto Stock Exchange Inc. (TSE) and the Investment Dealers Association of Canada (IDA) are proposing to create a stand alone market regulator. Once the market regulator is recognized as an SRO under securities legislation, RS and CDNX propose the following:

1. the market regulator will adopt the UMI rules, and
2. the TSE and CDNX will delete their existing market integrity rules.

RS and CDNX are further proposing that the UMI rules apply to trading of all types of securities traded on all exchanges and ATSSs.

**Background**

The CSA first published the ATS proposal for comment on July 2, 1999, and again on July 28, 2000. The ATS proposal provides a framework for regulating “marketplaces”, that is, exchanges, quotation and trade reporting systems and ATSSs.

In the ATS proposal, the CSA said that if a marketplace has certain characteristics, the marketplace would be regulated as an exchange. One of these characteristics is carrying out a market regulation function; this involves setting requirements governing the conduct of and disciplining marketplace participants. The proposal made it clear that ATSSs could not perform a market regulation function.

Exchanges have traditionally been market regulators: they have adopted rules, established surveillance systems to monitor compliance with those rules and taken enforcement action in appropriate circumstances. With the introduction of ATSSs into the Canadian market, the CSA has to establish an appropriate level of oversight for ATSSs without impeding their ability to compete with exchanges.

The July 1999 ATS proposal contemplated that an approved agent should perform the market regulation function for ATSSs. The CSA indicated that all exchanges in Canada were “approved agents”. Commenters raised concerns about conflicts of interest arising if exchanges do the market regulation function for ATSSs because exchanges and ATSSs compete for order flow. The July 2000 ATS proposal discussed possible alternatives:

1. creating an independent SRO for ATSSs (it was not clear, however, that ATSSs could, at least initially, support the cost of establishing and operating a separate market regulator);
2. consolidating market regulation for exchanges and ATSSs in an independent SRO; or
3. moving the market regulation of exchanges into separate divisions or subsidiaries to insulate them from the parts of the exchanges that compete with ATSSs.

The July 2000 ATS proposal requested that the industry consider and discuss possible alternatives to market regulation in the equity market. In response, the TSE and the IDA jointly proposed to create an entity to perform market regulation for the equity market. As proposed, the

market regulator would regulate trading in listed or quoted equity securities on the TSE, CDNX and ATSS. CSA staff are reviewing the following issues relating to the establishment of the market regulator: its governance structure, its fee structure, and the scope and content of the UMI rules.

The TSE and CDNX are publishing the UMI rules at this time in order to solicit comment on their scope and content. Attached is a copy of their notice and the UMI rules.

### **Scope of the Universal Market Integrity Rules**

The UMI rules set out the following general requirements for different marketplace participants:

1. **Marketplaces-** Certain requirements apply to marketplaces in general, such as clearing and settlement and trading halts.
2. **Participants-** Certain requirements apply to Participants, as defined in the UMI Rules. In general, under the UMI rules, Participants include the participating organizations of an exchange and the subscribers<sup>1</sup> of an ATS who are registered as dealers. The requirements that apply to Participants include the following: just and equitable principles of trade, manipulative and deceptive methods of trading, short selling, front running, best execution, order entry, order designation, clearing and settlement, trading supervision, proficiency and principal trading.
3. **Non-Dealer Subscribers-** Some of the rules also apply to the non-dealer subscribers<sup>2</sup> of an ATS. These requirements are limited in scope and include the following: just and equitable principles of trade, manipulative and deceptive methods of trading, short selling, and certain order designation requirements. As proposed under the UMI rules, an ATS would be required to ensure that its non-dealer subscribers have been trained in the applicable UMI rules. The non-dealer subscribers would then be responsible for complying with the UMI rules and, if they violated the rules, the market regulator would take enforcement action directly against the non-dealer subscribers.

### **General areas for comment**

CSA Staff solicit comments on two broad issues.

#### **a. *Scope and Content of UMI rules***

We are of the view that all marketplace participants should be subject to certain market integrity rules and that there should be consistent application and enforcement of those rules. We are currently discussing whether the market regulator should exercise jurisdiction over non-dealer subscribers in order to achieve consistent regulation.

Question 1: Are the scope and content of the UMI rules appropriate?

As currently drafted, the UMI rules will apply in their entirety to the participating organizations of exchanges and registered dealers that are subscribers of ATSS. Only certain of the UMI rules, however, will apply to non-dealer subscribers of ATSS (just and equitable principles of trade, manipulative and deceptive method of trading, and short selling).

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<sup>1</sup> "Subscriber" is defined in proposed National Instrument 21-101 as: "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 or submitting, disseminating or displaying orders on the ATS".

<sup>2</sup> "Non-Dealer Subscriber" is defined in the UMI rules as a subscriber who is not: (a) registered as a dealer under the securities legislation of any jurisdiction; or (b) a related entity of a Participant.

ATSs, which must be registered as dealers, would be responsible for ensuring that their non-dealer subscribers have received training in the relevant UMI rules. At this time, we do not contemplate that non-dealer subscribers would be subject to trading supervision obligations and proficiency requirements. We specifically request comment on the extent to which non-dealer subscribers should be regulated<sup>3</sup>.

Question 2: Should the market regulator regulate non-dealer subscribers directly and subject non-dealer subscribers to some or all of the trading supervision obligations described in section 7.2 of the UMI rules and to proficiency requirements? In the alternative, should there only be a requirement for an ATS to provide a copy of the rules to their non-dealer subscribers and ensure that they acknowledge that they have received the rules and understand them?

Question 3: Should the market regulator require that an ATS be responsible for training its non-dealer subscribers on the applicable rules?

**b. CSA Trading Rules**

At the same time as the ATS proposal, the CSA proposed certain basic common trading rules that would apply to all marketplaces (including marketplaces that trade listed or quoted equities, debt or derivative instruments) as well as trading in unlisted securities. The CSA acknowledged that, if ATSs are to be allowed to operate independently of recognized exchanges, they must follow trading practices that are similar to those established by exchanges for their marketplace participants.

RS and CDNX are proposing that the UMI rules apply to trading of all types of securities on all marketplaces. We are of the view that the UMI rules have been tailored to the equity market. We would have to analyze the UMI rules further to determine which parts should apply to the debt or derivatives markets. We received preliminary comments that indicate that several provisions, such as the order exposure requirement and the standard trading unit concept, do not apply to the derivatives market. Also, it is clear that some provisions do not apply to the debt market (other than the listed debt market).

In addition, the UMI rules do not apply to over-the-counter (OTC) trading, as OTC securities will not be traded on a marketplace. We are of the view that certain market integrity rules would be required at the CSA level in order to regulate OTC trading.

We specifically request comment on whether the UMI rules should form the basis for a single set of market integrity rules to replace all or part of the CSA Trading Rules. We also request comment on the extent to which the UMI rules are applicable to the debt and derivatives markets and OTC trading.

Question 4: Should the UMI rules replace all or part of the CSA Trading Rules<sup>4</sup> that were published for comment at the same time as the July 2000 ATS proposal?

Question 5: Please comment on the extent to which the UMI rules are applicable to the debt and derivatives markets and OTC trading.

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<sup>3</sup> Under TSE Rule 2-501 "Connection of Eligible Clients of Participating Organizations" (formerly Policy XXX), participating organizations may establish electronic links that allow a specified set of "eligible clients" to send orders electronically to the participating organization for routing to the TSE. In general, a participating organization that enters into an agreement with an "eligible client" to transmit orders received from the client is responsible for compliance with exchange requirements with respect to the entry and execution of orders transmitted by eligible clients through the Participating Organization.

<sup>4</sup> Proposed National Instrument 23-101 *Trading Rules*.

## Specific areas for comment

The CSA Staff request comment on the following specific areas of in the UMI rules:

### a. ***“Standard Trading Unit”***

The UMI rules provide a definition of “standard trading unit”. The TSE and CDNX notices provide a discussion of this definition. We agree that a concept of “standard trading unit” is necessary for purposes of the best bid price and the best ask price displayed by the data consolidator. In other words, although a marketplace could trade securities in any increment, the data consolidator should only display orders of comparable sizes. We request comment on whether the concept of a “standard trading unit” applies to the debt and derivatives markets.

Question 6: Does the concept of a standard trading unit apply to the debt and derivatives markets?

### b. ***Manipulative or Deceptive Method of Trading***

Under the CSA Trading Rules, it is an offence for a person to trade if the person “knows, or ought reasonably to know” that the transaction will result in or contribute to a misleading appearance of trading activity or in an artificial price for a security or perpetrates a *fraud* on any person. This section is modelled after securities legislation in some jurisdictions. However, the UMI rules provide that it is an offence for a participant or non-dealer subscriber to “use or knowingly facilitate or participate in the use of any manipulative or deceptive method of trading...”. This is an example of an area where it may be appropriate to retain rules at the CSA level that differ from the UMI rules.

We solicit comment on whether it is appropriate to provide an exemption from the provisions in the CSA Trading Rules relating to manipulation and fraud if a marketplace participant is in compliance with the manipulative and deceptive trading provisions in the UMI rules.

Question 7: Please comment on whether it is appropriate for an exemption to be granted from the CSA Trading Rules for manipulation and fraud if a marketplace participant is in compliance with the UMI rules.

### c. ***Best Execution Obligation***

The RS and CDNX notice provides a discussion of the best execution obligation in the UMI rules.

We are of the view that the best execution obligation is very important because it creates the potential for market participants to focus more on the opportunity for price improvement as they compete for order flow.

We specifically request comment on whether the best execution obligation in the UMI rules should be subject to “prevailing market conditions”. We also request comment on the exceptions to the best execution obligation contained in the UMI rules (part 5).

Question 8: Should the best execution obligation be subject to “prevailing market conditions”?

Question 9: Should there be exceptions to the best execution obligation? If so, what exceptions are appropriate?

### d. ***Display Requirements for Marketplace Participants***

The RS and CDNX notices provide a discussion of display requirements for marketplace participants.

We are of the view that exposure of client orders is important because the display of orders:

1. promotes transparency and provides marketplace participants with a more accurate picture of trading interest in a given security;
2. enhances execution opportunities for orders and is a valuable component of price discovery; and
3. encourages deeper and more efficient markets.

Question 10: Is the proposed threshold for order exposure of 50 standard trading units appropriate?

e. ***Principal Trading***

The RS and CDNX notices provide a discussion of principal trading. The CSA Trading Rules proposed that a marketplace participant that receives an order having a value of \$100,000 or less to buy or sell a security should not execute a principal transaction against that order unless the marketplace participant provides a better price (price improvement).

The UMI rules provide that a Participant that receives an order for 50 standard trading units or less with a value of \$100,000 or less may execute a client-principal cross if there is price improvement.

We request comment on the threshold set out in the UMI rules (section 8.1).

Question 11: Is the proposed threshold for principal trading of 50 standard trading units appropriate?

f. ***Audit Trail Requirements***

The CSA Trading Rules contemplate that the transmission of order information relating to the audit trail requirements is to be in electronic form. We are of the view that electronic transmittal of order information is necessary for market regulation purposes.

The audit trail requirements in the UMI rules do not specifically mention that the requirement to transmit the order information has to be met electronically. We solicit comment on whether the requirement to transmit the information in electronic form should be implemented over time.

Question 12: Should participants be permitted to implement the audit trail requirement regarding transmission of order information over time? If so, what would be the appropriate phase-in period?

g. ***Continuous/Timely Disclosure***

The RS and CDNX notices solicit comment on whether the UMI rules should be expanded to include specific responsibilities for the market regulator in respect of continuous/timely disclosure by issuers of securities that would trade on a marketplace.

As currently drafted, the UMI rules do not address continuous/timely disclosure obligations. CSA Staff will be reviewing this issue in the context of the recognition of the market regulator.

### **Summary of Requests for Comment**

In summary, comment is requested on the following issues:

Question 1: Are the scope and content of the UMI rules appropriate?

Question 2: Should the market regulator regulate non-dealer subscribers directly and subject non-dealer subscribers to some or all of the trading supervision obligations described in section

7.2 of the UMI rules and to proficiency requirements? In the alternative, should there only be a requirement for an ATS to provide a copy of the rules to their non-dealer subscribers and ensure that they acknowledge that they have received rules and understand them?

Question 3: Should the market regulator require that an ATS be responsible for training its non-dealer subscribers on the applicable rules?

Question 4: Should the UMI rules replace all or part of the CSA Trading Rules<sup>4</sup> that were published for comment at the same time as the July 2000 ATS proposal?

Question 5: Please comment on the extent to which the UMI rules are applicable to the debt and derivatives markets and OTC trading.

Question 6: Does the concept of a standard trading unit apply to the debt and derivatives markets?

Question 7: Please comment on whether it is appropriate for an exemption to be granted from the CSA Trading Rules for manipulation and fraud if a marketplace participant is in compliance with the UMI rules.

Question 8: Should the best execution obligation be subject to "prevailing market conditions"?

Question 9: Should there be exceptions to the best execution obligation? If so, what exceptions are appropriate?

Question 10: Is the proposed threshold for order exposure of 50 standard trading units appropriate?

Question 11: Is the proposed threshold for principal trading of 50 standard trading units appropriate?

Question 12: Should participants be permitted to implement the audit trail requirement regarding transmission of order information over time? If so, what would be the appropriate phase-in period?

### **Comments**

You are invited to make written submissions on the UMI Rules. We will consider submissions received within 30 days from the date of this Notice.

Please send your submission to all of the CSA 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 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 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](mailto:claudestpierre@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.