

**NOTICE OF NATIONAL INSTRUMENT 21-101
MARKETPLACE OPERATION, COMPANION POLICY 21-101CP AND
FORMS 21-101F1, 21-101F2, 21-101F3, 21-101F4, 21-101F5 AND 21-101F6**

AND

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

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MARKETPLACE OPERATION, COMPANION POLICY 21-101CP AND
FORMS 21-101F1, 21-101F2, 21-101F3, 21-101F4, 21-101F5 AND 21-101F6**

AND

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

1. BACKGROUND

The Commission and the other members of the Canadian Securities Administrators (the “CSA” or “We”), have made

- National Instrument 21-101 *Marketplace Operation* (“National Instrument 21-101”), Companion Policy 21-101CP and Forms 21-101F1, 21-101F2, 21-101F3, 21-101F4, 21-101F5 and 21-101F6 (together the “Marketplace Operation Rule”), and
- National Instrument 23-101 *Trading Rules* (“National Instrument 23-101”) and Companion Policy 23-101CP (together the “Trading Rules”).

The term “ATS Rules” refers to both the Marketplace Operation Rule and the Trading Rules. The full text of the ATS Rules is attached to this notice.

We first published the ATS Rules for comment on July 2, 1999 (“1999 Proposal”) and republished them for comment on July 28, 2000 (“2000 Proposal”). During the second comment period, which expired on October 30, 2000, we received 22 submissions. The names of the commenters, a summary of their comments and our responses are contained in Appendix A to this Notice. We thank all commenters for providing their comments on the two proposals. For additional background and the summary of comments received on the 1999 Proposal, please refer to the notices published with those proposals.

We have made some changes to the 2000 Proposal in response to the comments received and further consultation done. However, we are of the view that republication of the ATS Rules for comment is not required.

2. THE REGULATORY FRAMEWORK FOR ALTERNATIVE TRADING SYSTEMS

The ATS Rules are part of a CSA initiative to create a framework that permits competitive operation of traditional exchanges and other marketplaces, while ensuring that trading is fair and transparent. The ATS Rules set out a scheme for regulating ATSs by giving them a choice about how they will be regulated. The ATS Rules attempt to minimize fragmentation by setting out order and trade reporting requirements, information consolidation requirements and market integration requirements. In addition, the ATS Rules are designed to maintain and improve market integrity through National Instrument 23-101.

The regulatory objectives of the ATS Rules are as follows: to provide investor choice, improve price discovery and decrease execution costs. We have attached as Appendix B a chart that summarizes the transparency requirements and the market regulation obligations under the ATS Rules. The chart is being provided to assist readers; however, in the event of any inconsistency between the chart and the ATS Rules, the ATS Rules govern.

A. Regulatory Choice for Marketplaces

National Instrument 21-101 regulates all marketplaces operating in Canada. Marketplaces include exchanges, quotation and trade reporting systems and ATSs.¹ All marketplaces are subject to certain requirements, including information consolidation², market integration³, reporting and record keeping requirements⁴ and systems capacity requirements.⁵

A marketplace can choose one of three regulatory models under which to operate.

1. A marketplace can choose to be a member of an exchange, and thus be subject to the rules and policies of that exchange. If the marketplace chooses to be a member of an exchange, the marketplace is not subject to National Instrument 21-101.⁶
2. A marketplace can choose to be regulated as an exchange. A marketplace that decides to be regulated as an exchange must apply for recognition under securities legislation, file Form 21-101F1 and is subject to the requirements of securities legislation and the additional provisions of the ATS Rules that apply to exchanges.⁷ The Marketplace Operation Rule provides guidelines for

¹ “Marketplace” is defined in section 1.1 of National Instrument 21-101.

² Parts 7 and 8 of National Instrument 21-101.

³ Part 9 of National Instrument 21-101.

⁴ Part 11 of National Instrument 21-101.

⁵ Part 12 of National Instrument 21-101.

⁶ Section 2.1 of National Instrument 21-101.

⁷ Part 5 of National Instrument 21-101 imposes requirements on recognized exchanges and recognized quotation and trade reporting systems.

determining whether we would consider a marketplace to be an exchange. If a marketplace performs certain functions, we would consider the marketplace to be an exchange under securities legislation and would require it to be recognized as an exchange in order to carry on business, unless it obtains an exemption from securities regulatory authorities.⁸ These functions include providing a listing function, guaranteeing liquidity, setting requirements governing the conduct of marketplace participants, other than those necessary to govern the method of trading or algorithm used by those marketplace participants, and disciplining subscribers.

3. A marketplace can choose to be regulated as an ATS. A marketplace that decides to be regulated as an ATS must register as a dealer under securities legislation, become a member of a self-regulatory entity, file Form 21-101F2 and is subject to the additional provisions of the ATS Rules that apply to ATSs.⁹

Those marketplaces that fit within the statutory definition of a quotation and trade reporting system existing in certain provinces, cannot carry on business as a quotation and trade reporting system unless they are either recognized by the appropriate local jurisdiction or regulated as an ATS under the ATS Rules.

Inter-dealer bond brokers are excluded from the definition of a marketplace. They have a choice about how they will be regulated under the ATS Rules. An inter-dealer bond broker can choose to be subject to By-law No. 36 Inter-Dealer Bond Brokerage Systems (“By-law No. 36”) and Regulation 2100 Inter-Dealer Bond Brokerage Systems (“Regulation 2100”) of the Investment Dealers Association of Canada (the “IDA”). An inter-dealer bond broker that makes this choice is excluded from the definition of a marketplace under National Instrument 21-101 and is subject to the transparency requirements of Part 8 of National Instrument 21-101. We have requested that the IDA amend Regulation 2100 to remove the restriction on clients of inter-dealer bond brokers. The IDA will consider providing an exemption from this restriction until an amendment is finalized. Alternatively, an inter-dealer bond broker can choose to be an ATS and comply with the provisions of the ATS Rules that apply to marketplaces and ATSs.¹⁰

B. Securities to be Traded on an ATS

We have had extensive discussions with commenters on what securities should appropriately be traded on an ATS. Based on these discussions, we have determined at this time to restrict the securities that can be traded on an ATS.

⁸ Subsection 3.3(1) of Companion Policy 21-101CP.

⁹ Parts 6 and 13 of National Instrument 21-101 contain requirements applicable only to ATSs that are not members of an exchange or have not chosen to be recognized as an exchange.

¹⁰ Subsection 2.1(8) of Companion Policy 21-101CP.

Under National Instrument 21-101, an ATS shall not execute trades in securities other than exchange-traded securities, corporate debt securities, government debt securities and foreign exchange-traded securities.¹¹ Exchange-traded securities include equity securities, preferred securities, options and listed debt securities. An inter-listed security is an exchange-traded security. A security that is traded on a facility of an exchange, but is not listed on that exchange, or that is posted on an over-the-counter bulletin board, for example, Nasdaq's OTCBB, is not considered to be a foreign exchange-traded security and cannot be traded on an ATS.

An ATS that wants to trade over-the-counter equity securities may apply to the CSA. The CSA will consider such application and may allow an ATS to trade these securities if it is not contrary to the public interest to do so. To determine whether it is not contrary to the public interest, we will look at a number of factors including whether there are appropriate arrangements for issuer regulation.

C. National Instrument 23-101 Trading Rules

The Trading Rules set forth common trading rules that will apply to all trading, whether on a marketplace or not. They do not prohibit marketplaces from implementing additional rules. The requirements in the Trading Rules include a prohibition against manipulation and fraud¹² and a best execution obligation.¹³ The Trading Rules also impose an obligation on ATSs to enter a contract with a regulation services provider to conduct monitoring of the trading activities of the ATS and its subscribers and enforcement of the requirements of the regulation services provider. A regulation services provider is defined as a person or company that provides regulation services and is a recognized exchange, recognized quotation and trade reporting system or a recognized self-regulatory entity.¹⁴

Under the Trading Rules, a recognized exchange or recognized quotation and trade reporting system is required to set its own requirements and either enforce them directly or enter into an agreement with a regulation services provider that will monitor and enforce compliance with those requirements.¹⁵ In contrast, a regulation services provider for an ATS will adopt requirements that will apply to the ATS and the ATS will agree to comply with those requirements. Subscribers of the ATS will have to enter into an agreement with the ATS that indicates that the subscriber will comply with the requirements set by the

¹¹ Section 6.3 of National Instrument 21-101.

¹² Part 3 of National Instrument 23-101.

¹³ Part 4 of National Instrument 23-101.

¹⁴ Section 1.1 of National Instrument 21-101.

¹⁵ Part 7 of National Instrument 23-101.

regulation services provider of the ATS.¹⁶

Additional background and details about market regulation and the regulation services provider and its role are provided in Part 5 below.

3. TRANSPARENCY REQUIREMENTS UNDER THE ATS RULES

In order to minimize any negative impact of having different marketplaces trade the same security, the ATS Rules impose information transparency requirements on market participants trading exchange-traded securities, foreign exchange-traded securities and unlisted debt securities (corporate debt securities and government debt securities) and impose market integration requirements on all marketplaces. The market integration requirements are discussed in Part 4 below. As a part of the information transparency requirements, marketplaces trading exchange-traded securities or foreign exchange-traded securities must provide information to an information processor. A marketplace, inter-dealer bond broker and dealer trading unlisted debt securities must provide information to an information processor. The information processor will collect and disseminate the information received in the form of a consolidated feed. There may be more than one information processor, one for exchange-traded securities and foreign exchange-traded securities and one for unlisted debt securities.

A. Data Consolidation

(i) Exchange-Traded Securities and Foreign Exchange-Traded Securities

In the 2000 Proposal, the term “data consolidator” was defined as a person or company that has entered into an agreement with a securities regulatory authority to receive and provide information in accordance with Part 7 of National Instrument 21-101.¹⁷ In National Instrument 21-101, the term has been replaced with the term “information processor”. An information processor is defined as a person or company that receives and provides information in accordance with National Instrument 21-101 and files Form 21-101F5.¹⁸

We issued a Request for Proposal (“RFP”) on July 28, 2000 to select a developer and operator of the data consolidator. During the course of the negotiations with the entity selected to develop and operate the data consolidator, we decided to postpone the implementation of data consolidation for exchange-traded securities and foreign exchange-traded securities for a period of about two years. We will instead request

¹⁶ Part 8 of National Instrument 23-101.

¹⁷ Section 1.1 of National Instrument 21-101 of 2000 Proposal.

¹⁸ Section 1.1 of National Instrument 21-101.

that marketplaces and other industry participants develop and implement a solution to consolidate order and trade information for exchange-traded securities and foreign exchange-traded securities by December 31, 2003. In the meantime, National Instrument 21-101 provides an exemption from the requirement for marketplaces to provide order and trade information to an information processor on the condition that the marketplace provides the information to an information vendor. The exemption does not apply after December 31, 2003.¹⁹

(ii) Unlisted Debt Securities

An information processor will also collect and disseminate order and trade information for government debt securities and corporate debt securities. The information processor will collect the order and trade information for these securities provided by marketplaces, inter-dealer bond brokers and dealers and will create a consolidated feed and distribute it to information vendors, news services and other customers.²⁰

CanPX has filed Form 21-101F5 to become an information processor for unlisted debt securities in anticipation of the adoption of the ATS Rules. CanPX currently provides information transparency for the wholesale debt market. CanPX links together feeds from participating inter-dealer bond brokers and disseminates the best bid, best offer and last trade information for certain benchmarks and other designated government debt securities.

We will publish a notice indicating that CanPX has filed Form 21-101F5 in order to begin operations as an information processor for fixed income and that the form is publicly available for inspection. The notice will indicate that all interested parties can provide comments to us within 30 days of the publication of the notice. Upon the expiration of the comment period, we will review the comments received and prepare a recommendation indicating whether or not it is contrary to the public interest for CanPX to operate as an information processor under the ATS Rules. We will issue a notice indicating whether or not CanPX will be the information processor for unlisted debt securities.

(iii) Requirements Applicable to an Information Processor

The ATS Rules impose a number of requirements on an entity that becomes an information processor. A person or company that intends to carry on business as an information processor is required to file Form 21-101F5 at least 90 days before beginning to carry on business as an information processor.²¹ Upon receipt, we will review the form to determine if it is not contrary to the public interest to have that person

¹⁹ Section 7.5 of National Instrument 21-101.

²⁰ Part 8 of National Instrument 21-101.

²¹ Section 14.1 of National Instrument 21-101.

or company perform the consolidation function for a particular type of security (e.g, exchange-traded securities or unlisted debt securities). An information processor must enter into an agreement with each marketplace, inter-dealer bond broker and dealer providing information to the information processor. An information processor must

- provide timely, accurate, reliable and fair collection, processing, distribution and publication of information,
- keep the books, records and other documents that are necessary for the proper recording of its business transactions and financial affairs, and
- comply with specific systems requirements.²²

The purpose of filing the form and establishing requirements that apply to an information processor is to ensure the availability of prompt and accurate order and trade information and to assess the ongoing viability of the entity performing the consolidation function.

B. Transparency Requirements for Exchange-Traded Securities

(i) Order and Trade Information Transparency

The ATS Rules require that all marketplaces (exchanges, quotation and trade reporting systems, dealers executing exchange-traded securities outside of a marketplace and ATSs) that display orders of exchange-traded securities or foreign exchange-traded securities provide information on these orders to an information processor.²³ For exchange-traded securities or foreign exchange-traded securities, other than options, marketplaces are required to at least provide information on the type, the issuer, the class, the symbol and the series of the security, the five best bid prices and five best ask prices for each exchange-traded security and foreign exchange-traded security displayed and the total disclosed volume at each of those prices. For options, marketplaces must at least provide information on the underlying interest, the expiry month, the strike price, the best bid price and the best ask price for each option displayed and the total disclosed volume at each of those price levels. It is up to the individual marketplace to determine whether to show broker identification numbers and provide them to the information processor.²⁴ Individual marketplaces have to record broker identification numbers for audit trail purposes.

²² Part 14 of National Instrument 21-101.

²³ Subsection 7.1(1) of National Instrument 21-101.

²⁴ Subsection 9.2 of Companion Policy 21-101CP.

In addition, all marketplaces must provide details of all trades of exchange-traded securities and foreign exchange-traded securities to an information processor as required by the information processor.²⁵ For exchange-traded securities or foreign exchange-traded securities other than options, this information includes the type, issuer, class, symbol and series of the security, the volume, the price and time of the trade and any other information required by the information processor. For options, this information includes details of the underlying interest, the expiry month, the strike price, the volume, the price and time of the trade and any other information required by the information processor.²⁶

Marketplaces must provide the order and trade information to an information processor in real-time or as close to real-time as possible.²⁷

As discussed, we have provided an exemption from the transparency requirements for marketplaces trading exchange-traded securities or foreign exchange-traded securities if they provide the information to an information vendor. This exemption does not apply after December 31, 2003.²⁸

C. Transparency Requirements for Unlisted Debt Securities

(i) Order and Trade Transparency

We believe that it is important to improve transparency in the domestic debt markets. To that end, we have engaged in extensive discussions with debt market participants, the Bank of Canada, the provinces and the Department of Finance, Canada in order to determine the appropriate level of transparency for the debt markets. Based on these discussions and with the support of debt market participants, we have refined the transparency requirements applicable to marketplaces, inter-dealer bond brokers and dealers that trade corporate debt securities and government debt securities (together, “unlisted debt securities”). In the 2000 Proposal, marketplaces, inter-dealer bond brokers and market makers were required to provide all order and trade information to the information processor. The requirements for inter-dealer bond brokers have been amended and the market maker requirements have been replaced by dealer transparency requirements.

(1) Marketplaces

All marketplaces that display orders of unlisted debt securities must provide information regarding orders

²⁵ Section 7.2 of National Instrument 21-101.

²⁶ Subsection 9.1(4) of Companion Policy 21-101CP.

²⁷ Subsection 9.1(3) of Companion Policy 21-101CP.

²⁸ Section 7.5 of National Instrument 21-101.

for unlisted debt securities to the information processor as required by the information processor.²⁹ This information includes information on the type, issuer, coupon and maturity of the security, the best bid price, the best ask price and the total disclosed volume at those prices.³⁰ In addition, all marketplaces are required to provide information to the information processor on all trades of unlisted debt securities executed on the marketplace as required by the information processor.³¹ This information includes details as to the type, issuer, class and series of the security, the volume, the price and time of the trade and any additional information required by the information processor.³²

All marketplaces must provide order and trade information about unlisted debt securities to the information processor in real-time or as close to real-time as possible.³³

(2) *Inter-dealer Bond Brokers and Dealers*

An inter-dealer bond broker is required to provide information regarding orders of government debt securities traded through the inter-dealer bond broker to the information processor.³⁴ The information includes information on the type, the issuer, the coupon, and the maturity of the security, the best bid price, the best ask price and the total disclosed volume at those prices for benchmark and designated government debt securities.³⁵ The inter-dealer bond broker must provide this information in real-time or as close to real-time as possible.³⁶

In addition, inter-dealer bond brokers are required to provide information on trades of benchmarks and designated government debt securities and designated corporate debt securities that they trade within one hour of executing the trade.³⁷ Dealers are required to provide trade information on designated corporate debt securities traded by or through the dealer.³⁸ For each of these securities, an inter-dealer bond broker and a dealer must include information on the type, the issuer, the series, the coupon and the maturity of the security, the price and time of the trade and any additional information required by the information processor.³⁹ For government debt securities, inter-dealer bond brokers must also provide the volume traded.

²⁹ Section 8.1 of National Instrument 21-101.

³⁰ Subsection 10.1(2) of Companion Policy 21-101CP.

³¹ Section 8.2 of National Instrument 21-101.

³² Subsection 10.1(3) of Companion Policy 21-101CP.

³³ Subsection 10.1(4) of Companion Policy 21-101CP.

³⁴ Section 8.3 of National Instrument 21-101.

³⁵ Subsection 10.2(2) of Companion Policy 21-101CP.

³⁶ Subsection 10.2(10) of Companion Policy 21-101CP.

³⁷ Section 8.4 of National Instrument 21-101, subsections 10.2(10) of Companion Policy 21-101CP.

³⁸ Section 8.5 of National Instrument 21-101.

³⁹ Subsections 10.2(5) and (6) of Companion Policy 21-101CP.

For corporate debt securities, the volume information will depend on the total par value of the securities traded. For investment-grade corporate debt securities, inter-dealer bond brokers and dealers are required to provide the actual quantity of bonds traded if the total par value of the securities traded is \$2 million or less. For trades above \$2 million, inter-dealer bond brokers and dealers will show the volume information as \$2 million+. For non-investment grade corporate debt securities, inter-dealer bond brokers and dealers are required to provide the actual quantity of bonds traded if the total par value of the securities traded is \$200,000 or less. For trades above \$200,000, inter-dealer bond brokers and dealers will show the volume information as \$200,000+.⁴⁰

(ii) Selection of Unlisted Debt Securities

As stated above, transparency requirements for government debt securities traded through inter-dealer bond brokers apply only to benchmark and other designated government debt securities. The transparency requirements for corporate debt securities traded through an inter-dealer bond broker or traded by or through a dealer will apply initially to at least 20 corporate debt securities. The information processor will establish a list of government debt securities and corporate debt securities that it will display. The process for selecting the benchmark and designated government debt securities and the designated corporate debt securities and the list of designated unlisted debt securities will be posted on the websites of CanPX and the securities regulatory authorities. The information processor will review the benchmarks and designated government debt securities and designated corporate debt securities on a quarterly basis and update the list as necessary. If the list is amended, the information processor and the securities regulatory authorities will post the new list.

We have established the Bond Market Transparency Committee (the “Bond Committee”), which is made up of debt market participants, including issuers, investors, dealers and inter-dealer bond brokers. The Bond Committee will meet with us to discuss issues regarding the development and implementation of the ATS Rules. We will ask the Bond Committee to provide input to the CSA on issues including, but not limited to, fairness, integrity, efficiency, market competitiveness and usefulness of information gathered and disseminated, and technology issues relating to the collection and dissemination of data. It is intended that the Bond Committee will meet regularly to discuss issues relating to the fixed income market.

4. MARKET INTEGRATION

As stated, we are imposing market integration requirements onto marketplaces in order to minimize any negative impact of having different marketplaces trading the same security. The market integration requirements are located in Part 9 of National Instrument 21-101.

⁴⁰ Subsections 10.2(7) and (8) of Companion Policy 21-101CP.

Because market integration is a complex task that raises significant technology challenges, we have developed a two-phased approach. The requirements for the first phase are contained in subsection 9.2(1) and section 9.3 of National Instrument 21-101. The first phase will continue until January 1, 2004 and will require that a marketplace establish an electronic connection to the principal market for each security traded on that marketplace before executing a trade in that security.⁴¹ An information processor will determine the principal market for each security by ascertaining which marketplace had the largest trading volume for that security in the previous calendar year, will provide written notice to the marketplaces trading that security and will make the determination of the principal market publicly available.⁴² If there is no information processor, the securities regulatory authorities will determine the principal market.

The second phase of market integration will begin on January 1, 2004. The second phase requires all marketplaces to establish an electronic connection to a market integrator or, if there is no market integrator, to establish an electronic connection to each other.⁴³ At this time, we will not mandate a specific method of achieving complete market integration. Instead, we plan to monitor the number of marketplaces that operate in Canada and whether they create electronic connections to each other. If the industry achieves complete market integration voluntarily, it may not be necessary to create a market integrator.

5. TRADING RULES AND MARKET REGULATION

A. National Instrument 23-101 Trading Rules

In the past, each of the recognized exchanges implemented trading rules designed to establish fair and equitable trading practices and to prevent abusive and manipulative trade practices. If ATSS are to be allowed to operate independently of recognized exchanges, they and their marketplace participants must also follow similar practices. To ensure that ATSS are not used to avoid rules regarding the integrity of the capital markets, we developed the Trading Rules. The Trading Rules include a prohibition against manipulation and fraud⁴⁴, a best execution obligation⁴⁵, audit trail requirements⁴⁶ and an obligation for ATSS, inter-dealer bond brokers and dealers trading unlisted debt securities to enter a contract with a regulation services provider.

The Trading Rules set out requirements that we consider the minimum requirements applicable to all marketplaces and participants in the market. These rules may not be sufficient to ensure the integrity of a

⁴¹ Subsection 9.2(1) of National Instrument 21-101.

⁴² Section 9.3 of National Instrument 21-101.

⁴³ Subsection 9.2(2) of National Instrument 21-101.

⁴⁴ Part 3 of National Instrument 23-101.

⁴⁵ Part 4 of National Instrument 23-101.

⁴⁶ Part 11 of National Instrument 23-101.

marketplace. Consequently, we will evaluate any rules proposed, or lack of rules proposed, by a marketplace or regulation services provider to determine whether they are sufficient and appropriate.

(i) Application of the Trading Rules

We have provided for an exemption from the application of subsection 3.1(1) and Parts 4 and 5 of National Instrument 23-101. The exemption applies to those persons or companies that comply with the rules, policies and other similar instruments established by

- a recognized exchange or recognized quotation and trade reporting system, if that exchange or quotation and trade reporting system conducts its own market regulation, or
- a regulation services provider for an ATS, inter-dealer bond broker, dealer trading unlisted debt securities outside of a marketplace or a recognized exchange or recognized quotation and trade reporting system that contracts with a regulation services provider.

This exemption ensures that recognized exchanges and their members, recognized quotation and trade reporting systems and their users and marketplaces that have entered into an agreement with a regulation services provider and their marketplace participants are not subject to duplicative requirements. However, if a person or company does not comply with the requirements of the recognized exchange, recognized quotation and trade reporting system or regulation services provider, then the person or company is not exempt from the Trading Rules. Subsection 3.1(1) of National Instrument 23-101 does not apply in Alberta, British Columbia and Saskatchewan because these jurisdictions have provisions in their legislation that deal with manipulation and fraud. Therefore, the exemption from subsection 3.1(1) does not apply in those jurisdictions and the relevant provisions of the legislation apply.

(ii) Short Selling, Frontrunning, Insider Trading of Securities of Foreign Non-Reporting Issuers, Order Exposure Rule and Principal Trading

We have removed these provisions from National Instrument 23-101. We believe that restrictions relating to short selling, frontrunning, insider trading of securities of foreign non-reporting issuers, principal trading and order exposure obligations are important and suitable for all markets. However, we are of the view that identical provisions are not necessarily appropriate for each type of market, marketplace or each type of security. Consequently, when a regulation services provider, exchange or quotation and trade reporting system applies for recognition, we will review its proposed rules to determine if these provisions are included and whether the specific provisions are appropriate in the context of that market, marketplace or security.

(iii) Requirements of the ATS Rules for the Regulation Services Provider, Marketplaces, Inter-Dealer Bond Brokers and Dealers Executing Unlisted Debt Securities Outside of a Marketplace

The ATS Rules contemplate that a regulation services provider will provide monitoring and enforcement services to marketplaces. The concept of a “regulation services provider” replaces the reference to “approved agent” in the 2000 Proposal. A regulation services provider is defined as a person or company that provides regulation services and is a recognized exchange, recognized quotation or trade reporting system or a recognized self-regulatory entity.⁴⁷ At this time, Market Regulation Services Inc. has filed a draft application for recognition as a self-regulatory organization. Please refer to Paragraph 5B(i) of this Notice for a discussion of the filing. In addition, the IDA has filed a proposal for debt market regulation. Please see Part 5B(ii) for a discussion of the IDA’s proposal.

(1) Requirements for a Recognized Exchange and a Recognized Quotation and Trade Reporting System

Part 7 of National Instrument 23-101 provides that a recognized exchange or recognized quotation and trade reporting system must set requirements governing the conduct of its members or users. The requirements set by the recognized exchange or recognized quotation and trade reporting system will be reviewed and approved by the securities regulatory authorities. The recognized exchange or recognized quotation and trade reporting system has the option to monitor and enforce those requirements directly or it may contract with a regulation services provider to do this on its behalf. The requirements of a recognized exchange or recognized quotation and trade reporting system that monitor and enforces its own requirements directly may be different than those set by the regulation services provider for other marketplaces. A recognized exchange or recognized quotation and trade reporting system that does not monitor and enforce its own requirements must contract with a regulation services provider and use the services provided by the regulation services provider. Those services include using the rules of the regulation services provider.

(2) Requirements for an ATS

Part 8 contains the market regulation requirements that apply to an ATS. A regulation services provider must set requirements for an ATS. An ATS cannot execute a subscriber’s order unless the ATS has executed, and is subject to, certain written agreements. The first agreement is an agreement between the ATS and a regulation services provider. The agreement must provide that:

⁴⁷ Section 1.1 of National Instrument 21-101.

- the ATS will conduct its trading activities in compliance with the requirements of its regulation services provider,
- the regulation services provider will monitor the conduct of the ATS and its subscribers,
- the regulation services provider will enforce its requirements against the ATS and its subscribers,
- the ATS will comply with the record keeping requirements in National Instrument 21-101, and
- the ATS will comply with all orders or directions made by the regulation services provider.⁴⁸

Second, the ATS must enter into an agreement with each subscriber that provides that:

- the subscriber will conduct its trading activities in compliance with the requirements of the regulation services provider,
- the subscriber acknowledges that the regulation services provider will monitor the conduct of the subscriber and enforce its requirements against the subscribers, and
- the subscriber will comply with all orders or directions made by the regulation services provider, including orders that exclude the subscriber from trading on any marketplace.⁴⁹

(3) *Requirements for an Inter-Dealer Bond Broker*

Part 9 of National Instrument 23-101 contains the market regulation requirements that apply to an inter-dealer bond broker. The regulation services provider must set requirements for the inter-dealer bond broker. The inter-dealer bond broker must enter into a written agreement with the regulation services provider that provides that:

- the inter-dealer bond broker will conduct its trading activities in compliance with the requirements of the regulation services provider,
- the regulation services provider will monitor the conduct of the inter-dealer bond broker,
- the regulation services provider will enforce its requirements against the inter-dealer bond broker, and
- the inter-dealer bond broker will comply with all orders or directions made by the regulation services provider.⁵⁰

(4) *Requirements for a Dealer Executing Trades of Unlisted Debt Securities Outside of a Marketplace*

⁴⁸ Section 8.3 of National Instrument 23-101.

⁴⁹ Section 8.4 of National Instrument 23-101.

⁵⁰ Section 9.2 of National Instrument 23-101.

Part 10 of National Instrument 23-101 contains the market regulation requirements for a dealer trading unlisted debt securities outside of a marketplace. These requirements mirror the requirements that apply to an inter-dealer bond brokers in Part 9.

(iv) Regulation of the Debt Market - Exemption

National Instrument 23-101 provides ATSS trading unlisted debt securities, inter-dealer bond brokers and dealers trading unlisted debt securities outside of a marketplace an exemption from the requirement to enter into an agreement with a regulation services provider if the ATS, inter-dealer bond broker or dealer complies with IDA Policy No. 5. This exemption does not apply after December 31, 2003. We have provided this transitional exemption to ensure that dealers are subject to market regulation during the period between the effective date of the ATS Rules and the recognition of a regulation services provider for unlisted debt securities market. For more details, please see section B(ii) below.

B. Market Regulation by a Regulation Services Provider

In July 2000, the CSA published the 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. Eight commenters argued in favour of either direct regulation by the CSA or regulation by an independent self-regulatory organization (“SRO”).

In choosing a market regulator model, we will look at the following factors:

- Regulation should clearly and effectively address legitimate concerns without unnecessarily restricting competition.
- The primary objective of the regulatory framework should be to promote open and effectively competitive markets.
- The regulatory environment should neither favour nor constrain the ability of particular market participants to compete in the market.
- The regulatory process should be impartial and not self-serving i.e. the governing body should broadly represent all aspects of the industry being regulated.
- Governance of an SRO should ensure the transparency of self-regulatory activities i.e. independent public membership should balance industry representation on the SRO’s board of directors.
- An SRO should institute a formal complaint handling process.
- A regulatory scheme should allow for periodic assessment of its effectiveness and be subject to

regular reviews, such as audits and the filing of annual reports.

(i) *Exchange-Traded Securities and Foreign Exchange-Traded Securities*

In response to the request for comment on the market regulation issue, the Toronto Stock Exchange (the “TSE”) and the IDA outlined a proposal to regulate marketplaces trading exchange-traded securities and foreign exchange-traded securities. At the same time, TSE Regulation Services and the Canadian Venture Exchange Inc. developed the Universal Market Integrity Rules (the “UMI rules”). Those rules were published for comment on April 20, 2001. We expect that the proposed regulation services provider will adopt and administer the UMI rules.

Market Regulation Services Inc. (“RS Inc.”), a corporation to be jointly owned by the TSE and the IDA, has filed a draft application for recognition as a self-regulatory organization and as a regulation services provider. Once finalized, we will publish it for comment.

Initially, we expect that RS Inc. will provide regulation services to the TSE, CDNX and other marketplaces that retain its services. We are examining the application to determine if it is not contrary to the public interest to recognize RS Inc. as a self-regulatory organization. In reviewing the application, we are considering a number of factors, including:

- the factors identified above,
- the proposed ownership structure of RS Inc.,
- the proposed governance structure of RS Inc.,
- the applicability of the proposed UMI rules to a variety of marketplace models (auction markets, call markets, etc.), and
- the ability of both initial owners of RS Inc. to avoid or manage situations of conflicts of interest or the appearance of conflicts of interest relating to the self-regulatory obligations of RS Inc.

We expect that ATSS will contract with RS Inc. to monitor and enforce the UMI rules.

We note that we will review the requirements adopted by any regulation services provider, including RS Inc., to ensure that the requirements are appropriate.

(ii) *Unlisted Debt Securities*

Currently, all IDA member dealers trading domestic debt are subject to IDA Policy No. 5. We have received a proposal from the IDA to provide regulation services to ATSS, inter-dealer bond brokers and

dealers trading unlisted debt securities. This proposal is based on the requirements in IDA Policy No. 5. Until the proposal is finalized, we have provided an exemption to ATSS trading unlisted debt securities, inter-dealer bond brokers and dealers trading unlisted debt securities outside of a marketplace from the requirement to enter into an agreement with a regulation services provider if the ATS, inter-dealer bond broker or dealer complies with IDA Policy No. 5. IDA Policy No. 5 provides a regulatory regime that is tailored to the domestic debt market. It requires that dealers have standards and procedures relating to the trading of unlisted debt securities, that dealers ensure that their personnel are properly trained and qualified and that internal controls are in place to ensure that customer dealings are carried out on a confidential basis. As well, the policy sets out specific requirements for dealing with customers and counterparties, standards relating to market conduct, enforcement provisions and specific reporting requirements.

We have provided an exemption for ATSS trading unlisted debt securities, inter-dealer bond brokers and dealers executing trades of unlisted debt securities outside of a marketplace from having to enter into an agreement with a regulation services provider pursuant to NI23-101. This exemption does not affect the requirement for an ATS to become a member of the IDA or the requirement for ATSS and dealers that are members of the IDA to comply with the IDA's requirements. The exemption does not apply after December 31, 2003. Until that date, we will work with the IDA and debt market participants to develop and implement an appropriate structure for the regulation of the unlisted debt market. To that end, the CSA and the IDA will engage in a fact-finding exercise to identify and address any market integrity issues that may exist. Once the exercise is complete, we will determine if additional steps need to be taken to regulate the unlisted debt market.

C. Audit Trail Requirements

Part 11 of National Instrument 21-101 imposes recordkeeping requirements on marketplaces. These requirements require a marketplace to keep electronic records of certain information about orders and trades, among other things. An ATS is required to transmit information in electronic form to a regulation services provider when required by the regulation services provider.

Part 12 of National Instrument 23-101 sets record keeping requirements about orders and trades that are applicable to dealers. Dealers must transmit information to a regulation services provider when requested by the regulation services provider. We recognize that many dealers do not currently keep their records in electronic form. Consequently, we have given dealers two years to develop electronic recordkeeping capabilities. Between the implementation of the ATS Rules and December 31, 2003, we will facilitate discussions with the industry to determine the steps and the technology necessary to have all dealers move to electronic recordkeeping.

6. TRANSITIONAL PROVISIONS

We have included a number of transitional provisions into the ATS Rules. This section summarizes those provisions and cross-references the sections of this Notice where detailed discussions of the provisions can be found.

A. Transition for Transparency Requirements for Exchange-Traded Securities

Section 7.5 of National Instrument 21-101 provides an exemption for ATSS that trade exchange-traded securities from providing order and trade information to an information processor, if the information is provided to an information vendor at a reasonable cost. This exemption does not apply after December 31, 2003. Please see Part 3A of this Notice for a discussion of data consolidation requirements and the exemption.

B. Disclosure of Transaction Fees

Section 10.2 of National Instrument 21-101 provides an exemption for a marketplace that executes trades of exchange-traded securities and foreign exchange-traded securities from disclosing a schedule of transaction fees to the information processor provided that the marketplace makes the schedule of transaction fees publicly available. This exemption is not available after December 31, 2003.

C. Phase 1 and Phase 2 Integration

We have provided for two phases of market integration. The first phase will require marketplaces to connect to the principal market for the securities traded on the marketplace. This phase continues until January 1, 2004. On and after January 1, 2004, the second phase will require either all marketplaces to enter into an agreement with a market integrator, or if there is no market integrator, to establish an electronic connection to all other marketplaces. Please see Part 4 of this Notice for a detailed discussion of market integration.

D. Market Regulation

National Instrument 23-101 provides that an ATS trading unlisted debt securities, an inter-dealer bond broker and a dealer trading unlisted debt securities outside of a marketplace do not have to enter into an agreement with a regulation services provider if the ATS, inter-dealer bond broker or dealer complies with IDA Policy No. 5. This exemption does not apply after December 31, 2003. Please see Part 5A(v) and Part 5B(ii) of this Notice.

E. Audit Trail in Electronic Form

We are only requiring dealers to record and transmit information to a regulation services provider in electronic form after December 31, 2003. Please see Part 5C of this Notice for a detailed discussion of this deferred requirement.

7. IMPLEMENTATION OF THE ATS RULES

The effective date of the ATS Rules is December 1, 2001.

On that date, all ATSs currently operating in Canada must comply with the provisions of the ATS rules, including the requirement to be registered as a dealer in the appropriate jurisdictions.

If an ATS registered as a dealer in one jurisdiction in Canada provides access in another jurisdiction in Canada to subscribers who are not registered dealers under securities legislation, the ATS must be registered in that other jurisdiction. However, if all of the ATS's subscribers in the other jurisdiction are registered as dealers in that other jurisdiction, the securities regulatory authority in the other jurisdiction may consider granting the ATS an exemption from the requirement to register as a dealer under subsection 6.1(a) of National Instrument 21-101 and from the registration requirements of securities legislation.

8. QUESTIONS

Questions may be referred to any of:

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