Joint Canadian Securities Administrators

Market Regulation Services Inc. Notice on trade-through protection, best execution and access to marketplaces

Draft Regulation to amend
***Regulation 21-101 respecting Marketplace Operation,* Draft Regulation to amend *Regulation 23-101 respecting Trading Rules* and proposed amendments to related Universal Market Integrity Rules**

I. INTRODUCTION

The Canadian Securities Administrators (CSA) and Market Regulation Services Inc. (RS) have prepared this joint notice. As changes to the regulatory framework will result in amendments to CSA regulations and consequential amendments to RS's Universal Market Integrity Rules (UMIR), the CSA and RS believe that it is important to publish a joint notice to ensure consistency and assist in communication to market participants. Although both the CSA and RS have agreed to the contents of this notice, certain aspects are being proposed by the CSA and others by RS. We have specifically noted whether the CSA or RS is proposing a specific amendment. Where not specifically noted, references to "we" in this notice refer to both the CSA and RS.

The CSA are publishing proposals for comment that would amend *Regulation 21-101 respecting Marketplace Operation* (Regulation 21-101), *Regulation 23-101 respecting Trading Rules* (Regulation 23-101) (together, the ATS Rules) and the related policy statements. The purpose of the ATS Rules, which were put into place in December, 2001, was to respond to developments in the markets by establishing a framework that permits competition between traditional exchanges and other marketplaces while ensuring that trading is fair and efficient.[1]

Recent market developments have led to a review of the current rules. As a result, the CSA have concluded that changes should be made to the ATS Rules to reflect the current environment.[2] The CSA have focused on the following three key initiatives:

(1) a "trade-through" discussion, which describes a flexible framework for promoting the value in our markets that all marketplace participants should be treated fairly by requiring all immediately accessible, better-priced visible limit orders, regardless of the marketplaces on which they are entered, to be filled before other limit orders at an inferior price;

(2) proposed amendments to the best execution requirements, which currently limit best execution to achieving best price, to more broadly describe the factors to be considered in seeking best execution, including price, speed of execution, certainty of execution and overall cost of the transaction;[3] and

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1 See Notices for background at the Bulletin of the Commission des valeurs mobilières du Québec, Vol. XXX, no 34, 1999-08-27, the Bulletin of the Commission des valeurs mobilières du Québec, Vol. XXXII, no 35, 2001-09-31 and the Bulletin of the Autorité des marchés financiers, Vol. 01, no 20, 2004-06-18.

2 Amendments to certain other provisions in the ATS Rules were finalized at the end of December, 2006. These amendments extended the exemptions related to government bond transparency and electronic audit trail requirements and re-emphasized the CSA's position on best execution responsibilities in a multiple marketplace environment.

3 Draft amendments to Regulation 23-101, Part 4.

(3) proposed amendments that would establish requirements that must be met by non-dealers to gain access to a marketplace, including that a non-dealer must enter into an agreement with an exchange or a regulation services provider.[4]

At the same time, RS is publishing proposed consequential amendments to UMIR that are necessary as a result of the proposed CSA amendments. RS is recognized as a self-regulatory entity and a regulation services provider for the purposes of the ATS Rules. RS has adopted UMIR as a common set of market integrity principles that apply to all regulated persons in respect of the marketplaces for which RS is the regulation services provider. A regulation services provider provides regulatory services to its members (ATSs) as well as contracts to provide regulatory services on behalf of exchanges. As such, UMIR allows for the competitive operation of equity marketplaces in Canada under a common set of trading rules regulating various trading practices including: manipulative or deceptive methods of trading; short selling; frontrunning; best execution and best price obligations; order entry and order exposure; and client priority and client-principal trading. As the rules of a self-regulatory entity, the requirements under UMIR must be consistent with applicable securities legislation including the ATS Rules.

Part II of this notice reviews recent developments in the equity markets and theories on market structure as well as changes in trading behavior to evaluate whether the current market structure and/or objective should be changed. For background, Appendix A discusses the historical and current theories about how markets should be structured and the regulations that were introduced to promote the objectives that underlie those theories.

Part III considers the proposed regulatory responses and how they are intended to achieve the preferred market structure and objectives (and includes the alternatives that were considered and why they have been rejected). This part includes a discussion of both draft amendments to the ATS Rules and consequential amendments to UMIR.

II. RECENT DEVELOPMENTS AND CONTEXT FOR PROPOSED AMENDMENTS

The purpose of the discussion in this part is to review the changes in the equity markets and theories on market structures to consider whether the integrated market structure is still preferred.

A. The new developments

1. <u>ATSs trading Canadian listed equity securities.</u> Until 2005, ATSs that operated in Canada under the ATS Rules were foreign-based and they did not execute trades in Canadian exchange-traded securities. Trading in Canadian exchange-traded securities only occurred on the TSX, TSX Venture Exchange and, more recently, the Canadian Trading and Quotation System (CNQ).[5] As there are now multiple marketplaces operating in Canada using different execution methodologies to trade the same securities, there are a number of issues to be reconsidered, including whether the objectives and tools[6] regarding competing marketplaces are still relevant. Currently BlockBook, CNQ's Pure Trading, Bloomberg, Shorcan and Liquidnet trade TSX-listed securities and TriAct intends to trade TSX-listed securities upon launch of its operations. Liquidnet also trades TSX Venture securities. The rest of these marketplaces have also indicated that they may extend trading to securities listed on TSX Venture Exchange at a future date.

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4 Draft amendments to Regulation 23-101, Parts 7 and 8.

5 In 1999, the Toronto Stock Exchange, Bourse de Montréal, Vancouver Stock Exchange (VSE) and Alberta Stock Exchange (ASE) entered into an agreement where each exchange would specialize and would not compete for 10 years. The Winnipeg Stock Exchange merged with the entity created by the merger of the ASE and VSE.

6 For example, any technology or other methods to support the objectives.

2. Theories on how markets compete have changed. In the past, the assumption was that the basis of competition for trading was price only. This was supported by rules that stated that best execution is equivalent to best price. We have seen that the introduction of the ATS Rules has facilitated competition and innovation in the Canadian market by accommodating new marketplaces with diverse models of trading. This has included trading facilities which cater to particular niches, such as block transactions and specialized marketplaces where only a subset of participants can gain access (e.g. institutional investors only or dealers only). New trading technologies are being established to enable dealers and non-dealers alike to trade directly on a marketplace.

Marketplaces can now compete by trying to improve upon existing trading alternatives by differentiating on price, cost of execution, liquidity and speed of execution, among others.[7] Regulators have acknowledged this through their reconsideration of issues around best execution to take into account factors other than price.[8]

3. Decimalization. Decimal pricing was introduced in the U.S. in 2001. Although Canada introduced decimalization prior to this date, it moved to penny increments in 2001. The U.S. GAO study on decimal pricing indicated that although the trading costs measured in terms of spreads decreased as a result of decimalization, trading strategies also adapted. Traders adapted by using smaller orders and increasing their use of ATSs because decimalization reduced the minimum tick and lowered the risk for other traders to trade ahead of the larger orders.[9] However, the decrease in the size of limit orders can lead to a less efficient market from the perspective that there is less displayed interest in a security in terms of size and depth of the market.

4. Increasing use of marketplaces with no pre-trade transparency and matching facilities. Uninformed traders value transparency.[10] There is evidence that institutional investors use ATSs when they are informed, and use the upstairs market when they are uninformed. This is supported by the evidence that institutional investors have been increasingly using marketplaces that do not have any pre-trade transparency, i.e., no orders or quotes are available. There are other reasons these facilities are gaining in popularity including concerns over information leakage and anonymity.

Some of these systems are crossing networks that provide opportunities for trading at a point between the bid and ask being shown on a transparent market. Others provide for sequential negotiations until there is a matching in interest. Going dark, i.e., removing information from the book, hampers the incorporation of information into prices. The reduction in transparency or migration of order flow away from the dominant transparent marketplace worsens overall price discovery.

5. More facilities for internalization. In addition, order management systems have increased the ability of the dealers and large institutional investors to consolidate and match their multiple sources of orders. Such orders are required to be printed on a marketplace, but they are matched within the dealer's or institutional investor's system without going into the book.

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[7] Current academic literature shows that marketplaces compete on speed, depth, and anonymity as well as price (Conrad, Johnson and Wahal, "Institutional Trading and Alternative Trading Systems").

[8] See, for example, Concept Paper 23-402 *Best execution and soft dollar arrangements* published on February 4, 2005 by staff of the BCSC, ASC, MSC, AMF and the OSC. The purpose of the concept paper was to set out a number of issues related to best execution and soft dollar arrangements to obtain feedback. See Part III.B of this Notice for discussion of proposed changes.

[9] *Decimal pricing has contributed to lower trading costs and more challenging trading environment* (U.S. Government Accountability Office, May 2005).

[10] "Island Goes Dark; Transparency, Fragmentation and Regulation" (2005) 18 Review of Financial Studies 743-793 at 759.

In Canada, this trend toward identifying internal matches prior to entry onto a marketplace is the extension of existing marketplace technology that allows “in-house” priority at a given price level. For example, the TSX’s trading engine seeks out and gives priority to matching trades of a dealer’s clients before matching trades between clients of different dealers.

Internalization raises questions about the value of the information in the book and the price discovery process.

6. Removal of requirements for data consolidation and market integration. In 2001, the ATS Rules identified a number of regulatory objectives that include providing investor choice as to execution methodologies or types of marketplaces and improving price discovery and market integrity. The ATS Rules also set out requirements relating to data consolidation and market integration to minimize any negative impact of having multiple markets trading the same securities, and market regulation rules. Due to the uncertainty of how many and which new marketplaces would develop, the requirements relating to data consolidation and market integration were postponed and an industry committee was struck to specifically consider these issues. In 2003, the ATS Rules were amended to delete the concepts of a data consolidator and a market integrator, based on the recommendation of the industry committee that these concepts were not necessary as a result of best execution requirements for dealers and fair access requirements for marketplaces (which would make information available through information vendors). Although the data consolidation requirement was removed, the ATS Rules still required marketplaces to provide data on orders and trades to an information processor or information vendor. Notwithstanding current obligations, some industry members have expressed concern about the inability or difficulty of complying with best execution and other obligations without an official regulated feed that identifies where the best priced order(s) are located. Also, RS may be required to create its own consolidated feed for regulatory purposes.

B. Approaches in other jurisdictions

1. U.S. developments. There have been recent market structure developments in the United States. On April 6, 2005, the Securities and Exchange Commission (SEC) approved, in a 3-2 decision, Regulation (Reg) NMS which will significantly alter the trade-through rules in the United States.

Historically, trade-through rules were established in the U.S. on a marketplace-by-marketplace basis. Until recently, Nasdaq operated without trade-through rules. The New York Stock Exchange (NYSE) adopted a rule for NYSE-listed securities. Due to the fact that the NYSE was not electronic, the ATSs that traded NYSE securities complained that the trade-through rule put them at a significant disadvantage by requiring them to send orders to the NYSE to meet the trade-through obligations, which meant these orders could be held up for significant amounts of time, diminishing the ATSs’ main value propositions of fast and certain execution.

Reg NMS requires trading centers[11] to establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent trade-throughs, and, if relying on one of the exceptions, which are reasonably designed to assure compliance with the exception. To be protected, a quotation must be immediately and automatically accessible. Trade-through protection will apply to the best bid and offer from every type of participant on all of the marketplaces. One of the impacts of this order protection is increased linkages between market centers. Reg NMS includes a number of exceptions from “order protection” obligations, including for: opening or closing orders, crossed markets,

[11] “Trading Center” under Reg NMS “means a national securities exchange or national securities association that operates an SRO trading facility, an alternative trading system, an exchange market maker, an OTC market maker, or any other broker or dealer that executes orders internally by trading as principal or crossing orders as agent.”

benchmark orders where the material terms are not known, intermarket sweep orders, delays in responses caused by systems problems, and flickering quotes.

On March 5, 2007, the Trading Phase of Reg NMS began, which required market centers to be capable of routing orders to other systems. The roll-out of Reg NMS will continue on July 9, 2007, when securities firms will be required to comply with the trade-through provisions of Reg NMS for 250 pilot stocks. All stocks will be introduced on August 20, 2007 with a completion date of October 8, 2007.

2. European developments. The European Union (EU) is preparing to implement the Markets in Financial Instruments Directive (MiFID) as part of its Financial Services Action Plan designed to create a single market in financial services for EU member states. MiFID focuses on best execution and will require all EU jurisdictions to adopt the same policy. For most EU member states, price is not the only consideration in determining best execution.

In the United Kingdom, the Financial Services Authority does not have a trade-through rule, whereas the London Stock Exchange does.[12]

C. Current preferred market structure

Through our consultations and review of recent studies, we have noted that most market participants believe that the ideal or preferred equity market structure is to have integrated marketplaces. Although this does not mean that there would be mandatory linkages between marketplaces, the theory is that, to reduce the negative impact of multiple marketplaces trading the same securities, there should be access to information and orders. The reasons or values in determining the preferred market structure ("objectives") reflect the following: price discovery, liquidity, competition, innovation, market integrity and fairness.

Most market structure specialists think that lack of transparency and integration are the main reasons for imperfect competition among securities markets and that regulatory changes that increase competition and facilitate integration improve market quality.[13]

We think that there continues to be value in a market structure that promotes the interaction of orders, creates incentives to place transparent limit orders and allows participants to identify and execute against the best available limit orders. Market participants and commentators have described the ideal structure as one that brings together all types of participants in a transparent and efficient manner. Access by different types of marketplace participants requires that the rules are appropriately applied to all participants to promote fairness. The objectives set out above are still relevant. Some reduction in transparency and competition among marketplaces based on factors other than prices does not, in our view, undermine the value of the integrated marketplaces.

III. PROPOSED REGULATORY RESPONSES

As new marketplaces have now emerged trading the same securities, we are considering whether regulatory responses are necessary to continue to meet the objectives set out above (i.e., price discovery, liquidity, competition, innovation, market integrity and fairness). In order to do that, we have focused on trade-through protection, best execution and access.

Within the multiple marketplace environment, we have identified differences in the way the current rules apply to marketplace participants. For example, the existing UMIR trade-through rule (called the

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12 London Stock Exchange Rules 4425 and 4426 for SETSmm securities, Rules 5520 and 5521 for SEAQ securities and Rules 6000 and 6225 for SEATS Plus securities.

13 "Island Goes Dark; Transparency, Fragmentation and Regulation" (2005) 18 Review of Financial Studies 743-793.

"best price" requirement) only applies to dealers. With new marketplaces offering direct access to non-dealer subscribers, not all participants are currently subject to a trade-through rule.

With respect to best execution, there have been innovations and developments in how marketplaces compete. Specifically, marketplaces now compete on factors other than price and as a result, requirements need to be updated to reflect the current environment. In addition, as noted above, direct access to marketplaces has expanded beyond dealers. This results in non-dealer participants being subject to different regimes depending on how they are accessing a marketplace.

Part A below discusses a proposal for trade-through protection (in the boxed portion), the background, the key aspects of the proposal and the alternatives considered. We are not, however, publishing draft regulations or proposed rules at this time on trade-through. Part B discusses best execution including a description of the draft amendments to the ATS Rules, the background and the key aspects of the amendments, and consequential UMIR amendments. Part C discusses access requirements for non-dealers including a description of the draft amendments to the ATS Rules, the background and the key aspects of the amendments, as well as consequential amendments to the UMIRs. Part D discusses other draft amendments to the ATS Rules.

A. Trade-through Protection

At this time, we are only publishing a proposal on trade-through to set out the direction currently being considered, though the issue is not yet settled. As reflected in the comments filed in response to the discussion paper, there are different views and, before publishing specific draft regulations or proposed rules, we would like to solicit feedback about the direction of the proposal.

Description of trade-through proposal

General Proposal

- Require each marketplace to establish, maintain and enforce written policies and procedures that are reasonably designed to prevent trade-throughs (this is similar to the general rule set out in Reg NMS)

- Marketplaces would be required to regularly review the effectiveness of the policies and procedures and take prompt action to remedy deficiencies

Application

- Trade-through protection would apply to a "protected order", when purchasing or selling an "exchange-traded security" [14] (other than derivatives)

- We would consider a "protected order" to be a limit order (other than an "excluded order") that is displayed and can be "immediately and automatically" executed against

- An "excluded order" would be defined as an order that is subject to a term or condition, where the

[14] "Exchange-traded security" is defined in the ATS Rules as a security that is listed on a recognized exchange or quoted on a recognized quotation and trade reporting system or is listed on an exchange or quoted on a quotation and trade reporting system that is recognized for the purpose of the ATS Rules.

price cannot be determined at the time of order entry or where the price is determined by reference to prices achieved in one or more derivatives transactions (these would be similar to the current exemptions in UMIR)

Exceptions – when the trade-through obligation would not apply

- The order was displayed by a marketplace that was experiencing a systems issue (a "failure, material delay or malfunction of its systems or equipment")
- The order was identified as an "intermarket sweep order" (a new type of order that would facilitate compliance with these new obligations – see below)
- A flickering quote led to the trade-through

1. Background

On July 22, 2005, the CSA published Discussion Paper 23-403 *Market Structure Developments and Trade-through Obligations* (discussion paper).[15] The purpose of the discussion paper was to discuss evolving market developments and the consequential implications for our market, in particular the obligation to avoid trade-throughs (trade-through obligation).

The current rules relating to trade-through protection are in the UMIR administered by RS.[16] In particular, the trade-through obligation is referenced as part of the best price obligation under UMIR. Until recently, no issues arose under the rules because

- there had not been multiple marketplaces trading the same securities in Canada[17],
- the technology systems of existing marketplaces enforced the best price obligation, and
- only dealers had direct access to the existing marketplaces.

With the establishment of new ATSs, the existence of multiple marketplaces trading the same security has refocused attention on the current rules relating to trade-through protection.

RS has been monitoring trading on the marketplaces that it regulates for trade-throughs. At this time, we have insufficient data and experience with trading on multiple marketplaces to come to any conclusions. RS will continue to monitor trading as new marketplaces emerge.

The discussion paper asked a number of questions to get feedback on what values and rules were important to market participants in the Canadian market. Because of the importance of the issues relating to the trade-through obligation and their potential impact on the Canadian capital markets, the CSA held a

15 See the Bulletin of the Autorité des marchés financiers, Vol. 2, no 29, 2005-07-22 for background.

16 See UMIR Rule 5.2.

17 See footnote 5.

public forum on October 14, 2005 to permit all interested parties to participate in discussions relating to trade-through protection.[18]

The CSA received 29 comment letters from marketplaces, dealers, and large, buy-side clients and received feedback on a number of issues identified in the discussion paper where there was often no clear majority opinion and the views on either side of a given issue were approximately split. However, the majority of commenters stated that they believed that all visible orders at a better price should trade before inferior-priced orders; it is this value that serves as the policy basis for a trade-through rule.

Many market participants believe that trade-through obligations are key in maintaining investor confidence and fairness in our markets. It can be argued that trade-through obligations create an incentive for investors to place limit orders on a marketplace as they have confidence that if their order is at the best price, it will be protected and filled before orders at inferior prices. This fosters confidence and encourages more liquidity in the market as well as a more efficient price discovery process.

2. Key aspects

Based on the analysis above, we considered a framework to protect all visible, better-priced, immediately accessible limit orders across all marketplaces. Set out below is a summary of the key aspects upon which the proposal is premised.

(a) *An obligation to avoid trade-throughs is part of a duty owed by all market participants to the market in general*

The vast majority of commenters believe that a trade-through obligation is a duty owed by all marketplace participants to the capital markets (and is not based on fiduciary duty). The value in having a rule that provides protection for visible limit orders across marketplaces is that it can promote transparency and perceptions of fairness. The trade-through proposal would in its effect extend to all marketplace participants (dealers and non-dealer participants). This approach is intended to promote price discovery, integration and fairness where there are different types of marketplaces and access.

(b) *l marketplaces would be required to establish, maintain and enforce written policies and procedures that are reasonably designed to prevent trades at prices that are inferior to the price of a visible order on any marketplace*[19]

With respect to where the obligation should be placed (i.e., marketplace or marketplace participant), the commenters to the discussion paper were approximately split between those who believed that the marketplace should be responsible for ensuring that trade-throughs do not occur and those who believed the individual participants should have the responsibility.

We are proposing that a general obligation be placed on marketplaces to establish, maintain and enforce written policies and procedures that are reasonably designed to prevent trade-throughs within and across marketplaces. This would allow the industry to determine how best to implement the necessary changes. The purpose would be to promote price discovery, competition and fairness.

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18 The transcript of the trade-through forum is published on the OSC website at: http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part2/rule_20051014_23-403_trade-through-forum.pdf.

19 The term “marketplace” refers to a Canadian marketplace (either an exchange, quotation and trade reporting system or ATS).

Placing this obligation on marketplaces would require effective monitoring and enforcement of a marketplace's policies and procedures and how they are implemented. At this time, it is contemplated that the CSA would be responsible for performing oversight and enforcing an exchange's compliance with the general obligation (based on the lead regulator model) and RS would be responsible for enforcing an ATS' compliance with this obligation. Depending on how a marketplace complies with its obligations, there may also be a need for oversight of dealers and non-dealers in accordance with the access provisions set out in Regulation 23-101. In order to ensure consistent requirements and oversight, RS will be implementing amendments that parallel the CSA requirements.

It is important to note that placing the obligation on a marketplace to establish, maintain and enforce written policies that are reasonably designed to prevent trade-throughs does not mean that marketplaces would be required to establish linkages with other marketplaces. Many of the comments received assumed that placing the obligation on the marketplaces would mean mandatory linkages.

We think that there are alternative ways a marketplace could choose to implement its policies and procedures obligation without requiring mandatory linkages. Some examples include:

- Preventing orders from being entered into the marketplace when they are not at the best available prices.

- Preventing orders from being executed if not at the best price.

- Providing price improvement so that the transaction is executed at the same or a better price to that available on another marketplace.

- Requiring participants to take certain specified actions or to more generally confirm their own policies and procedures.

- Allowing the entry of "intermarket sweep orders" (as defined below).

- Establishing voluntary linkages (direct or indirect through an entity that has access to other marketplaces) to the other marketplaces to route orders to the best available visible limit orders.

Although the obligation to establish, maintain and enforce written policies to prevent trade-throughs would rest with the individual marketplaces, the decision about how to implement the requirement would be a choice and an opportunity for marketplaces to differentiate themselves and their services. The policies adopted by an individual marketplace may differ; however, the end result is intended to be the same for all marketplaces - the minimization of trade-throughs.

We would like to specifically request comment on the need to also impose an obligation on marketplace participants regarding execution of an order on a foreign marketplace. If the trade-through obligation is imposed at the marketplace level, the requirements of any marketplace would not be effective in preventing a market participant from trading through better-priced orders on a Canadian marketplace by directing its trading activity to markets outside Canada. The protection of better-priced orders on a Canadian marketplace may be necessary given the significance of securities listed on a Canadian exchange that are also inter-listed or traded on an organized regulated market outside of Canada. Trading in such securities represents a much larger percentage of trading on Canadian marketplaces than it does on U.S. markets like the NYSE. The fact that the Reg NMS order protection rule does not address trading on foreign markets in this way might be explained by the much lower significance of foreign trading of U.S.-listed securities for U.S. markets. Furthermore, as noted above, the price discovery function can be argued to be more important on Canadian marketplaces because they are comparatively less deep and liquid than U.S. markets.

The provision for a supplementary obligation on market participants would result in the regulatory burden being imposed at both levels (that is, marketplaces and market participants) in relation to trading on foreign markets. We are therefore specifically requesting comment on the need to impose a supplementary obligation directly on market participants to require them to execute "better-priced" orders on a Canadian marketplace prior to or concurrent with the execution on a foreign market.

Question 1: In addition to imposing a general obligation on marketplaces to establish, maintain and enforce written policies and procedures to prevent trade-throughs, would it also be necessary to place an obligation on marketplace participants to address trade execution on a foreign market?

We recognize that a trade-through obligation will likely have a cost impact on some market participants. We will be preparing a cost-benefit analysis of the trade-through proposal and will be soliciting input from interested parties.

Question 2: What factors should we consider in developing our cost-benefit analysis for the trade-through proposal?

Question 3: Would you like to participate in the cost-benefit analysis by providing your input?

(c) *Trade-through protection would apply to any exchange-traded security (other than derivatives) that is a "protected order" (defined below)*

We propose that trade-through protection would focus on exchange-traded securities (other than derivatives). The majority of commenters thought the initial focus should not be on fixed income and derivatives trading because each has its own unique characteristics. While we propose to limit the scope of the trade-through obligation to exchange-traded securities, other than derivatives, depending on the outcome of implementation, we may also examine the possibility of establishing similar requirements in the fixed-income and derivatives markets at a later date.

We note that, subject to certain exceptions, the order-protection rule in Reg NMS applies during regular trading hours (which are defined as the time between 9:30 a.m. and 4:00 p.m. Eastern time, unless otherwise specified). We are considering defining regular trading hours in a regulatory context, which is relevant for purposes of regulating trade-through. We are specifically requesting comment on whether trade-through protection should be applied (subject to certain exceptions discussed below) only during "regular trading hours".

Question 4: Should trade-through protection apply only during "regular trading hours"? If so, what is the appropriate definition of "regular trading hours"?

(d) *Trade-through protection would apply to the visible portions of all automatically accessible better-priced orders ("protected orders") regardless of the marketplace on which they are entered*

The majority of commenters supported trade-through protection that would apply to all visible orders regardless of where they are in the book. In other words, the majority were supportive of a full depth-of-book obligation. As a result, the proposal applies to all protected orders that are visible. This differs from the model adopted in the United States through Reg NMS, which offers order protection to the top of the book of each automated market center whose orders qualify for order protection.

When and if there is an information processor, it is intended that it would provide full depth-of-book information for all visible orders that are equity securities. However, we are specifically requesting comment on whether we should consider limiting the consolidated feed to a certain number of levels, e.g., the top five, and concurrently limit trade-through obligations to that number of levels.

In addition, the proposal would only apply to "protected orders" as described above. We have included this to account for the different trading methodologies used by marketplaces to distinguish between automated marketplaces and marketplaces that require some form of human intervention. The purpose of this distinction is to promote fairness and innovation.

Question 5: Should the consolidated feed (and, by extension, trade-through obligations) be limited to the top five levels? Would another number of levels (for example, top-of-book) be more appropriate for trade-through purposes? What is the impact of the absence of an information processor to provide centralized order and trade information?

(e) *Trade-through proposal would impose a limit on what a marketplace could charge to access a better-priced order*

We think that it is important to establish a maximum amount that a visible marketplace can charge for access to a quote. The purpose is to ensure that the best visible quote will be the best available price after factoring in such access fees, and would not lead to the converse – i.e. that it will appear to be the best price but the up front cost of accessing it will make it actually inferior.

It should be noted that this is only aimed at the marketplace fee to access a quote. Other costs of the transaction may be considered as part of best execution. Our intention in establishing a limitation on access fees is to help ensure that prices are comparable across marketplaces. This is meant to address the extent to which the price, once the order is accessed, could vary from the displayed price. We are specifically requesting comment on the fee limitation.

Question 6: Should there be a limit on the fees charged on a trade-by-trade basis to access an order on a marketplace for trade-through purposes?

(f) *Specialized Marketplaces*

The current ATS Rules impose fair access requirements on an ATS to not unreasonably prohibit, condition or limit access by a person or company to services offered by it. We have interpreted the fair access requirements to allow an ATS to set access criteria that limit access to a specific type of marketplace participant (for example, only institutional subscribers) as long as it is not contrary to the public interest. The result has been an increasing number of ATSs that limit access to a specific group ("specialized marketplaces"). This ability to limit access is constrained by the requirement that if an ATS reaches 20% of the average daily trading volume in a particular security they must notify the securities regulatory authority to discuss whether or not the ATS should be regulated as an exchange (which is subject to a higher degree of regulation). At that time, the CSA would also consider whether continuing to limit access was appropriate.

Recent amendments to UMIR specifically recognize that a dealer may not have a best price obligation to a better-priced order on every marketplace.[20] In order for a Participant (as defined in UMIR) to demonstrate that it had made "reasonable efforts" to execute a client order at the best price, RS expects the Participant will deal with "better-priced" orders that are visible on another marketplace if that marketplace:

- disseminates order data in real-time and electronically through one or more information vendors;
- permits dealers to have access to trading in the capacity as agent;
- provides fully-automated electronic order entry; and
- provides fully-automated order matching and trade execution.

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[20] Reference should be made to Market Integrity Notice 2007-002 - Amendment Approval - Provisions Respecting Competitive Marketplaces (February 26, 2007).

Question 7: Should the CSA establish a threshold that would require an ATS to permit access to all groups of marketplace participants? If so, what is the appropriate threshold?

Assuming that the trade-through obligation is an obligation owed to the market in general, for purposes of the trade-through rule, all specialized marketplaces with immediately accessible, visible limit orders should not discriminate against non-members. This could require them to allow order execution on behalf of non-members who need access to better-priced quotes. Alternatively, access could be provided through a member (or subscriber). The member (or subscriber) would, in turn, charge a fee to the non-member for providing this service. In other words, a marketplace must not prohibit access to non-members who access the quote through a member (or subscriber) in an attempt to satisfy the trade-through obligation. It is important to note that any separate "order execution" access would be granted for the purposes of satisfying the trade-through obligation and is distinguished from the broader access/membership, which may include the ability to display limit orders and orders with different markers.

Question 8: Should it be a requirement that specialized marketplaces not prohibit access to non-members so they can access, through a member (or subscriber), immediately accessible, visible limit orders to satisfy the trade-through obligation?

- ***Should an ATS be required to provide direct order execution access if no subscriber will provide this service?***

- ***Is this solution practical?***

- ***Should there be a certain percentage threshold for specialized marketplaces below which a trade-through obligation would not apply to orders and/or trades on that marketplace?***

(g) *A trade-through obligation does not eliminate or lessen a participant's best execution requirements*

With the trade-through proposal, all trading in exchange-traded securities other than derivatives would be subject to the requirements, described above. This would not eliminate a marketplace participant's best execution obligations. The proposal would require an order to be executed at the best available price, but the dealer or adviser with the best execution obligation would be required to understand the characteristics and quality of the available marketplaces in making the determination when, where and how to route orders. For a more detailed discussion on best execution see below.

(h) *Exceptions*

As previously mentioned, the overall purpose of trade-through protection is to promote a fair marketplace where the visible portions of better-priced limit orders trade ahead of inferior-priced orders. It is important to acknowledge, however, that the issues relating to preventing all trade-throughs in a multiple marketplace setting are very complex. They are further complicated by the speed at which order routing and execution occurs. We think that because competing marketplaces offer different speeds and certainty of execution, offering price protection across marketplaces is a challenging task.

Set out below is a discussion of possible exceptions. The purpose of the exceptions is to promote fairness, innovation and competition. Exceptions from the general obligation should be justified on policy grounds and should not present an opportunity for regulatory arbitrage between marketplaces. For example, participants should not have an incentive to route orders to a particular marketplace to avoid regulatory requirements applicable to others.

We have separated the discussion of exceptions into the following categories: existing exceptions under UMIR, exceptions to facilitate proposed requirements in a multiple marketplace environment and additional exceptions that attempt to balance potentially conflicting needs of participants.

i. Existing Exceptions

Currently, under UMIR, a participant has an obligation to make reasonable efforts to execute against better-priced orders, but would not be required to do so in certain circumstances. The majority of commenters were supportive of maintaining the current exceptions in UMIR, including for special terms orders. In general, there are three broad categories of orders that are excluded from the obligation:

- Where the price of the trade is not known at the time of the entry or the execution of the order (e.g., call market orders, market-on-close orders, opening orders and volume-weighted average price orders);

- Where the price is determined by reference to prices achieved in one or more derivatives transactions (e.g., basis orders); and

- Where certain conditions are attached to the execution (e.g., special terms orders).

We are generally supportive of these broad categories of exemptions. However, currently under UMIR, the exemption for a special terms order does not apply in certain circumstances. There is a concern that a broad exemption for all special terms orders could be open to abuse if the addition of a condition could avoid all trade-through obligations.

Question 9: Are there any types of special terms orders that should not be exempt from trade-through obligations?

ii. Exceptions to facilitate proposed requirements

Systems Issues

From time to time a marketplace may experience technical difficulties. We think it is necessary to provide an exception from the obligation to access protected orders when a marketplace is experiencing any of the following: a technical failure, a malfunction or a material delay. This exception is intended to provide marketplaces with flexibility when dealing with another marketplace that is experiencing technological systems problems (either of a temporary nature or a longer-term systems issue). It supports fairness to participants by clarifying when a marketplace is not considered to be operating properly.

Flickering Quotes

As previously discussed, the speed at which trades occur and the difficulties with ensuring trade-through protection across marketplaces create a situation where it is almost impossible to stop every occurrence of trade-throughs. The increase of algorithmic and black box trading, which generate multiple short-term orders (sometimes generated and cancelled within seconds) for every trade executed, have increased the number of times a better-priced order may be displayed. Given the speed with which these quotes change, there may be technical occurrences of trade-throughs, even though all reasonable precautions were taken and there was a legitimate attempt to execute a trade at the best available price.

We are considering an exception to acknowledge that a trade may occur that has the appearance of a trade-through but was the result of a flickering quote. In other words, it was the best available price at the time of order entry, however, due to rapidly moving quotations, it was not the best available price at order execution.

***Question 10: Are there current technology tools that would allow monitoring and enforcement of a flickering quote exception*?**

Question 11: Should the exception only apply for a specified period of time (for example, one second)? If so, what is the appropriate period of time?

Intermarket Sweep Order

An intermarket sweep order is an order that indicates that the entity responsible for generating the order (participant or marketplace) has performed a check as to the location of the best available visible, better-priced orders and is attempting to execute against these orders. A marketplace that receives a "intermarket sweep order" has no further obligation to ensure that there is no better available price. This exception may also facilitate the immediate execution of large block orders. For example, if a market participant would like to execute an order that would trade through one or more better-priced orders on other marketplaces, the market participant will be able to do so if it simultaneously routes one or more intermarket sweep orders to execute against the full displayed size of each better-priced order. This is intended to simplify compliance with the trade-through obligation.

iii. Additional exceptions

After-hours Trading Session

Although we are requesting comment on whether trade-through protection should apply during "regular trading hours", marketplaces may set different hours of operation. Some marketplaces provide an after-hours trading session at a price established by that marketplace during its regular trading hours. This is important for market participants, such as mutual funds, who are required to benchmark to a certain closing price. We are considering an exception from the trade-through obligation for trades in such a facility.[21] The exception would allow trades to occur in an after-hours trading session at a specific marketplace's closing price without having to execute against better-priced orders on other marketplaces. This promotes fairness to those who must achieve a certain price. RS has amended UMIR to provide for a "Closing Price Order" to facilitate trading after regular trading hours on any marketplace at the closing sale price of a particular security on that marketplace.[22]

Question 12: Should this exception only be applicable for trades that must occur at a specific marketplace's closing price? Are there any issues of fairness if there is no reciprocal treatment for orders on another marketplace exempting them from having to execute at the closing price in a special facility if that price is better?

Last sale price order facility exception

In addition, we are considering an exception from trade-through requirements for the two original parties of a trade on a visible block trading facility for any residual trading that may occur within a specified timeframe as long as the original trade was at the best available price and of a minimum order size. The rationale for permitting the last sale price order facility is to help facilitate the execution of any volume remaining after the execution of a large block trade (which has been executed at the best price). Several marketplaces have indicated they would like to offer a facility that would allow their participants to trade residual volume of orders without a resulting trade-through obligation. They argue that the original trade was subject to the trade-through rule, and that opportunistic traders may take advantage of the information and attempt to profit from it. The last sale order price facility exception would allow the original parties to the block trade to complete any remaining volume of their trade without any resulting trade being subject to the trade-through obligation for a limited amount of time. After this time, all new trades would be subject to the trade-through obligation.

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[21] UMIR amendments in force as of March 9, 2007 include an exemption from the best price obligation for closing price orders. See reference in note 20.

[22] Ibid, note 20.

Question 13: Should a last sale price order facility exception be limited to any residual volume of a trade or should it apply for any amount between the two original parties to a trade? What is the appropriate time limit?

Other Exceptions

There may be other types or characteristics of orders that should appropriately be subject to an exception from the trade-through obligation.

Question 14: Should trade-throughs be allowed in any other circumstances? For example, are there specific types or characteristics of orders that should be subject to an exemption from the trade-through obligation?

3. Consequential UMIR amendments

Current Requirements

Under Rule 5.2 of UMIR, a Participant has an obligation to make reasonable efforts to fill better-priced orders on a marketplace before executing a trade at an inferior price on another marketplace or a foreign market. In Policy 5.2, RS indicated that it would consider whether the Participant is a member, user or subscriber of the marketplace with the best price when determining whether a Participant has made "reasonable efforts" to obtain the best price on the execution of the client order. The "best price" obligation under Rule 5.2 and Policy 5.2 applies to trading undertaken by a Participant as principal or as agent for a client. Access Persons trading on a marketplace are not subject to the "best price" obligation.

Proposed Amendments

Prior to the issuance by the CSA of Discussion Paper 23-403 – *Developments in Market Structure and Trade-Through Obligations*, RS published Market Integrity Notice 2005-016 – *Request for Comments – Interim Provisions Respecting Trade-Through Obligations* (May 12, 2005). RS had proposed certain interim amendments to UMIR pending the completion of the study arising out of the Discussion Paper. RS has not pursued the approval of these amendments and RS would intend to withdraw those proposed amendments upon implementation by the CSA of a trade-through obligation in the ATS Rules. RS will propose to make consequential amendments to UMIR to conform with the requirements on the trade-through obligation proposed by the CSA following consideration of comments received as a result of this joint notice. Any consequential amendments proposed by RS will be issued in a Market Integrity Notice and open for comment during the same period as any amendments regarding trade-through proposed by the CSA for the ATS Rules.

4. Alternatives Considered

Set out below is a brief summary of alternatives considered and reasons for not proposing to adopt these alternatives.

(a) *Maintain status quo and introduce order execution reporting obligations*

One alternative would be to maintain the status quo with respect to trade-through. The current rules place the obligation not to trade-through better-priced orders only on dealers. Non-dealer participants have no obligation to trade at the best available price. This option would impose a reporting obligation on dealers to provide details as to where they are routing and executing orders and require each marketplace to provide information about the trading occurring on that marketplace. The reports would be made publicly available and all marketplace participants could use the information to help inform routing decisions. This would also be a tool to assist dealers and advisers in achieving best execution.

Our main concern with this alternative is that the current rules place different requirements on dealer and non-dealer participants of a marketplace. In addition, the current trade through requirements are tied to best execution rules in the UMIR. While trade-through obligations and best execution are related, we think they are two separate obligations. We also think that placing a general obligation on marketplaces to establish, maintain and enforce written policies and procedures that are reasonably designed to prevent trade-throughs is more flexible to allow industry to determine how best to implement changes.

Further, while the reporting obligations on marketplaces and dealers could provide useful information about order routing and execution, it would still be the case that different requirements would apply to dealer and non-dealer participants of a marketplace.

(b) *Exclusion for highly liquid securities*

Another alternative considered was to exempt highly liquid securities or securities with minimal spreads while imposing a trade-through requirement on less liquid securities. The rationale behind this approach is that limit orders are more likely used by retail clients in smaller, less liquid stocks and trade-through protection is needed to encourage participants to continue to use limit orders. If participants placing limit orders in an illiquid stock continually see their limit orders bypassed they may stop placing these types of orders.[23] For trading in highly liquid securities, it is generally assumed that the spread and arbitrage across marketplaces will keep the prices on different marketplace in a tight range and therefore a trade-through rule may not be needed.

This approach is not consistent with the view that the prevention of trade-throughs is a duty owed to the market. Another issue with this alternative would be defining what would be considered “highly liquid” and how this would be monitored in the event trading patterns changed. In addition, it may be difficult for participants to know whether a security is exempt.

(c) *Mandatory Linkages for marketplaces with greater than a certain percentage of trading*

Another alternative considered was to impose the obligation that, when a marketplace reaches a “critical mass” in trading (for example, 10% of market share in trading), it must integrate with other marketplaces that have achieved the critical mass. There would be no obligation to integrate with a marketplace that has not done so. Prior to a marketplace reaching this threshold, there would only be a trade-through obligation if a participant chose to access that marketplace.

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[23] Kiem, Madhavan, “Transaction costs and investment style: An inter-exchange analysis of institutional equity trades”.

Although we considered this alternative, we had concerns that this would favour incumbent marketplaces. In addition, it is not consistent with the view that trade-through protection is an obligation to the markets as a whole. Further, this alternative would require mandatory market integration (at 10%) as opposed to a more flexible solution that allows marketplaces to decide how to implement trade-through protection.

B. Best Execution Requirements

Description of proposed best execution amendments

Definition

- "Best execution" is defined as trading at the "most advantageous execution terms reasonably available under the circumstances"

General rule

- Requires dealers and advisers to obtain "best execution" (and expands reference beyond "best execution price")

Additional guidance

- Number of factors that may be considered in seeking "best execution" – extending beyond price to include speed, certainty of execution and overall cost of the transaction

1. Background

On February 4, 2005, staff of the British Columbia Securities Commission, the Alberta Securities Commission, the Manitoba Securities Commission, the Autorité des Marchés financiers and the Ontario Securities Commission published Concept Paper 23-402 *Best execution and soft dollar arrangements* (concept paper).[24] The purpose of the concept paper was to set out a number of issues related to best execution and soft dollar arrangements[25] to obtain feedback.

In the concept paper, the CSA reflected the commonly held view that there is no simple, purely objective definition of best execution. The CSA emphasized that it is difficult to define best execution because there are many factors that may be relevant in assessing what constitutes best execution in any particular circumstance. It had been equated with achieving the best price but has more recently been acknowledged as having broader considerations and that it requires greater focus on the process. The CSA suggested some key elements of best execution: 1) price; 2) speed of execution; 3) certainty of execution; and 4) total transaction cost. We also raised the issue of measurement as this is critical to any meaningful analysis of best execution.

Based on the feedback obtained through the consultation process[26], we are proposing changes to the current best execution requirements in Regulation 23-101, which reflect existing obligations in UMIR.

[24] Bulletin of the Autorité des marchés financiers, Vol. 2, no 5, 2005-02-04.

[25] Amendments to current provisions relating to soft dollar arrangements are being dealt with in a separate proposal.

[26] Smmary of comments received published at the Bulletin of the Autorité des marchés financiers, Vol. 2, no 50, 2005-12-16.

The consequential amendments being made to UMIR by RS harmonize UMIR wording to the CSA rule and policy proposals.

2. Key aspects

We are proposing the following amendments to update and clarify the best execution provisions in Regulation 23-101[27]:

(a) *Definition of best execution and obligation to provide best execution*

To reflect the breadth of considerations for best execution, the CSA are proposing to amend the provisions to include factors other than price. Currently, there is no definition of “best execution”. Instead, section 4.2 of Regulation 23-101 refers to “best execution price” when describing the obligation applicable to a dealer. In addition, requirements in UMIR begin with a general obligation and then focus more specifically on price. In response to questions raised in the concept paper, many commenters stated that the current best execution requirements are too narrow and that the focus of best execution should be on the process and not an absolute standard to be applied on a trade-by-trade basis.

In light of the comments received on the concept paper, the CSA are proposing the following definition of best execution: the most advantageous execution terms reasonably available under the circumstances.[28] The Policy Statement clarifies that the application of the definition will vary depending on the specific circumstances, and also, on who is responsible for obtaining best execution.[29] In assessing the most advantageous execution terms reasonably available under the circumstances, the key elements identified (i.e., price, speed of execution, certainty of execution and overall cost of the transaction) are relevant. These key elements encompass more specific considerations such as liquidity, market impact or opportunity costs.

Question 15: Are there other considerations that are relevant?

Question 16: How does the multiple marketplace environment and broadening the description of best execution impact small dealers?

(b) *Application of best execution to dealers*

The best execution obligation would require that a dealer use reasonable efforts to achieve best execution. Where a security trades on multiple marketplaces, it does not necessarily require dealers to maintain access to all marketplaces. To achieve best execution, a dealer should assess whether it is appropriate to consider all marketplaces, both within and outside of Canada, upon which a security is traded. The CSA also propose to clarify that “best execution” will vary depending on the particular circumstances and that a dealer should be able to demonstrate that it has a process and has relied on that process in seeking the desired outcome.[30]

(c) *Application of best execution to advisers*

Current securities law requirements provide that advisers have a general responsibility to act in the best interests of their clients. This has been codified in certain instruments, for example, OSC Rule

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27 It should be noted that the proposals are in addition to any applicable common law requirements.

28 Draft amendments to Regulation 23-101, s. 1.1.

29 Draft amendments to Policy Statement 23-101, s. 1.1.1.

30 Draft amendments to Policy Statement 23-101, s. 4.1.

31-505 *Conditions of Registration* (section 2.1), which sets out the general requirement for advisers to deal fairly, honestly and in good faith with their clients. There are also some specific obligations set out in securities legislation (for example, fair allocation of trades among client accounts).

In updating the best execution requirements, the CSA have acknowledged their application to advisers.[31] The CSA recognize that an adviser's obligations (generally assessed on a portfolio basis) often differ from a dealer's obligations (generally related to specific trades). The CSA have also sought to ensure that these best execution obligations are not inconsistent with standards set by professional organizations (such as the CFA Institute). However, where an adviser chooses to retain control of all trading decisions, including via direct access, the obligations will be similar to a dealer's. Therefore, the CSA have clarified the application of the best execution obligation to an adviser.[32]

Question 17: Should the best execution obligation be the same for an adviser as a dealer where the adviser retains control over trading decisions or should the focus remain on the performance of the portfolio? Under what circumstances should the best execution obligation be different?

(d) *Reporting of order execution and market quality information*

In the concept paper, the CSA referred to SEC rules on disclosure of order routing and execution practices. One rule (Rule 605 under Reg NMS, formerly rule 11Ac1-5) requires market centers (defined to mean any exchange market maker, OTC market maker, alternative trading system, national securities exchange or national securities association) to make monthly, electronic disclosure of information concerning quality of execution. A second rule (Rule 606, formerly rule 11Ac1-6) requires brokers that route orders on behalf of customers to disclose on a quarterly basis the identity of the market centers to which they route a significant percentage of their orders. In addition, brokers are required to disclose the nature of their relationships with such market centers, including any internalization or payment for order flow arrangements that could represent a conflict of interest between the brokers and their customers. Brokers are also required to respond to the requests of customers interested in learning where their individual orders were routed for execution during the previous six months.

The CSA received mixed feedback. Some suggested that similar rules may be advantageous in Canada, but some raised questions regarding the value of the information received. As a result of the comments, the CSA have tailored the information to focus only on areas that we think would provide important information to assess quality of execution.

The CSA are of the view that transparency of certain information is important to provide tools for assessing and complying with the best execution obligation. Therefore, the proposal includes requirements both on a marketplace[33] and on a dealer[34]. With respect to a marketplace, the CSA are proposing that certain information be reported on a monthly basis, including: the number of orders, the number of trades executed and speed of execution. The CSA are of the view that this information would be relevant for a dealer or adviser to assess best execution based on marketplace quality (for example, speed and certainty of execution). This information could be used by technology providers for order routing purposes as well as for establishing compliance. The CSA think the reports would provide information for clients to use to question and understand the best execution practices of their intermediaries.

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31 Draft amendments to Regulation 23-101, s. 4.2.

32 Draft amendments to Policy Statement 23-101, s. 4.1.

33 Draft amendments to Regulation 21-101, Part 14.1.

34 Draft amendments to Regulation 23-101, Part 11.1.

In addition, the CSA are proposing the following information be reported by dealers on a quarterly basis: percentage of orders executed at a location determined by the dealer; identity of marketplaces and percentage of orders routed to each marketplace; disclosure of any material arrangements with a marketplace.

For the CSA's cost-benefit analysis of these proposed reporting requirements, please see the document entitled "Cost Benefit Analysis – Proposed Amendments to National Instrument 21-101 *Marketplace Operation* and National Instrument 23-101 *Trading Rules*" (the CBA).

Question 18: Are there any other areas of cost or benefit not covered by the CBA?

The CSA specifically request comment on the proposed reporting for marketplaces and dealers.

Question 19: Please comment on whether the proposed reporting requirements for marketplaces and dealers would provide useful information. Is there other information that would be useful? Are there differences between the U.S. and Canadian markets that make this information less useful in Canada?

Question 20: Should trades executed on a foreign market or over-the-counter be included in the data reported by dealers?

Question 21: Should dealers report information about orders that are routed due to trade-through obligations?

Question 22: Should information reported by a marketplace include spread-based statistics?

Question 23: If securities are traded on only one marketplace, would the information included in the proposed reporting requirements be useful? Is it practical for the requirement to be triggered only once securities are also traded on other marketplaces? Would marketplaces always be in a position to know when this has occurred?

3. Consequential UMIR amendments

Current UMIR Requirements

Rule 5.1 of UMIR requires a Participant to diligently pursue the execution of each client order on the most advantageous terms for the client as expeditiously as practicable under prevailing market conditions.

Proposed UMIR Amendments

Concurrent with the publication of this joint notice, RS has issued Market Integrity Notice 2007-008 - *Request for Comments – Provisions Respecting Best Execution* (April 20, 2007), that proposes additional changes to the rules and policies under UMIR respecting "best execution" to parallel the proposed provisions of the ATS Rules and the policy statement with respect to "best execution" obligations of a dealer when handling a client order.

The provisions dealing with "best execution" proposed for Regulation 23-101 will apply to both dealers and advisers. The amendments to UMIR will adopt the language proposed for the "best execution" obligation for Regulation 23-101. However, the UMIR obligation will only be applicable to Participants and will not apply to an adviser even if the adviser is trading on a marketplace in the capacity of an "Access Person".

C. Direct Access Issues

Description of proposed direct access amendments

Who is a dealer-sponsored participant?

- A person or company that has dealer-sponsored access to a marketplace, and is an "Institutional Customer" as defined by IDA Policy No. 4 *Minimum Standards for Institutional Account Opening, Operation and Supervision*, as amended, and includes the representatives of the person or company

Compliance and monitoring requirements

- Requires exchanges to set requirements for dealer-sponsored participants and the dealers who provide such access and to monitor trading activities and enforce requirements either directly, or retain a regulation services provider to do so

- Requires a regulation services provider to set requirements for an ATS, its subscribers and the dealer-sponsored participants, and to monitor trading activities and enforce its requirements

- In addition to required agreements between the ATS and its subscribers and the exchange and its members, requires an agreement between each subscriber and the regulation services provider and each dealer-sponsored participant and the entity responsible for monitoring (either the exchange or regulation services provider)

- Imposes an obligation on dealers that provide dealer-sponsored access to maintain a list of dealer-sponsored participants and supervise trading

Training

- Trader Training Course examination (currently, a requirement for dealers trading on a marketplace) or another examination relating to an approved course or training

- Understanding of the applicable system requirements

1. Background

Currently, there is a different regulatory regime applicable to non-dealer "direct" participants (these are generally buy-side institutions but in the future could be retail) depending on how they are accessing a marketplace. The difference is between "direct" intermediated access (i.e., through or "sponsored by" a dealer) to an exchange or ATS, and direct access to an ATS (by a subscriber). In Canada, access sponsored by a dealer is often referred to as "DMA".

UMIR impose compliance obligations on dealers and subscribers of an ATS (included in the UMIR definition of "access person"). The obligations of a subscriber of an ATS under the current obligations are limited to a small subset of UMIR provisions including: the requirement to use open and fair practices; the prohibition on the use of manipulative or deceptive methods of trade; and the restrictions on short selling (as well as some order marking requirements).

If a non-dealer that is an "eligible client" has entered an order through an interconnect agreement with a dealer to trade on a marketplace (for example, using TSX Rule and Policy 2-501 access), that client would not be subject to any of the provisions of UMIR and would not be subject to disciplinary or enforcement action under UMIR. On the other hand, if that same non-dealer is a subscriber to an ATS and enters orders directly on the ATS, the limited subset of UMIR provisions set out above would apply.[35]

The distinction between trading as an eligible client and trading as a subscriber to an ATS leads to different regulatory treatment that does not reflect essentially equivalent trading activity:

- ATS subscribers are subject to RS's jurisdiction; eligible clients are subject to CSA jurisdiction. This division of jurisdiction between RS and CSA in relation to direct access trading may lead to different enforcement outcomes because a dealer who sponsors direct access trading is subject to RS's jurisdiction, while that dealer's eligible clients are subject to CSA jurisdiction. In addition, not all UMIR provisions are mirrored by provisions in the statutes, regulations and rules administered by the CSA (including those relating to improper orders and trades, short sales and order marking), meaning that such provisions apply to trading by ATS subscribers but do not apply to trading by eligible clients.

- Eligible clients trading through a dealer are currently subject to certain rules that do not apply to ATS subscribers, including the existing trade-through rule in UMIR (as these clients access a marketplace through a dealer who has these obligations).

- Dealers have monitoring and compliance responsibilities for trading by their eligible clients under Part 7 of UMIR; ATSs do not presently have the same responsibilities under UMIR for trading by their subscribers.

We are therefore including amendments to deal with the differing requirements that exist between a subscriber of an ATS and a client that enters an order electronically after having signed an agreement with a dealer for DMA.

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[35] The UMIRs that would apply are Rule 2.1 Just and Equitable Principles, Rule 2.2 Manipulative and Deceptive Activities, Rule 3.1 Restrictions on Short Selling, and Rule 6.2 Designations and Identifiers.

2. Key aspects

In order to address the issue of differing requirements and ensure that participants that are not dealers are subject to the same rules whether they enter an order directly on an ATS (as a subscriber) or through DMA, we are proposing amendments dealing generally with access.

The CSA are proposing a new definition of "dealer-sponsored participant" which is a person or company whose "direct" access to a marketplace is through a dealer (this would only apply to institutional customers). The CSA think it is important to clarify the obligations for all parties: marketplaces, dealers (whether as members of an exchange or subscribers to an ATS), and dealer-sponsored participants, whether foreign or domestic.

Both the exchange and ATS are responsible for ensuring compliance with their rules or contractual requirements regarding who may be granted "dealer-sponsored access". As well, an exchange would be required to monitor and enforce requirements regarding the trading of dealer-sponsored participants and would have the choice of doing so directly or indirectly through a regulation services provider. The exchange would also be required to set requirements for its members to review and report activity of the dealer-sponsored participants who access the exchange through such members.[36] An ATS would be required to retain a regulation services provider for monitoring the trades on the ATS and the conduct of the subscribers and dealer-sponsored participants.[37] It is also important to clarify that an ATS does retain some compliance responsibility for its marketplace. This applies to situations where the ATS may be a better position than a regulation services provider to obtain information. For example:

- An ATS may have information about relationships between different subscriber accounts, which may be required to detect patterns of activity across subscriber accounts; and

- An ATS may have information about failed trades involving subscribers which is relevant for monitoring short sales.

The CSA acknowledge that an ATS may not be in a position to perform real-time compliance; however, we think that post-trade review may be appropriate, depending on the circumstances. The regulation services provider should identify (subject to public comment and regulatory approval), the responsibilities of the ATS for activities of subscribers and dealer-sponsored participants and for monitoring those activities.

As set out above, there are currently certain limited market integrity rules that apply to ATS subscribers. The CSA expect that these requirements will continue to apply to subscribers of an ATS and would be applied to dealer-sponsored participants, whether foreign or domestic, that have direct access to an ATS through a dealer subscriber or to an exchange through a member. An exchange or a regulation services provider would be able to impose additional requirements applicable to dealer-sponsored participants, subject to public comment and approval by the applicable securities regulatory authorities.[38]

The CSA are also proposing that there be certain training requirements applicable to dealer-sponsored participants (either the Trader Training Course examination, which is currently a requirement applicable to dealers trading exchange-traded securities (other than derivatives), or another examination

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36 Draft amendments to Regulation 23-101, s. 7.1.

37 Draft amendments to Regulation 23-101, ss. 8.1 and 8.2.

38 Draft amendments to Policy Statement 23-101, s. Part 7.

relating to a course or training that is acceptable to the applicable regulatory securities authority, exchange or regulation services provider).[39]

Question 24: Should DMA clients be subject to the same requirements as subscribers before being permitted access to a marketplace?

Question 25: Should the requirements regarding dealer-sponsored participants apply when the products traded are fixed income securities? Derivatives? Why or why not?

Question 26: Would your view about the jurisdiction of a regulation services provider (such as RS for ATS subscribers or an exchange for DMA clients) depend on whether it was limited to certain circumstances? For example, if for violations relating to manipulation and fraud, the securities commissions would be the applicable regulatory authorities for enforcement purposes?

Question 27: Could the proposed amendments lead dealer-sponsored participants to choose alternative ways to access the market such as using more traditional access (for example, by telephone), using foreign markets (for inter-listed securities) or creating multiple levels of DMA (for example, a DMA client providing access to other persons)?

Question 28: Should there be an exemption for foreign clients who are dealer-sponsored participants from the requirements to enter into an agreement with the exchange or regulations services provider? If so, why and under what circumstances?

Question 29: Please provide the advantages and disadvantages of a new category of member of an exchange that would have direct access to exchanges without the involvement of a dealer (assuming clearing and settlement could continue to be through a participant of the clearing agency).

3. Consequential UMIR amendments

Current UMIR Requirements

UMIR presently applies to and imposes obligations on persons who are either a “Participant” or an “Access Person”. Generally speaking, UMIR defines a “Participant” as a dealer that is a member of an exchange, user of a quotation and trade reporting system (QTRS) or subscriber to an ATS. Presently, UMIR defines an “Access Person” as a person, other than a Participant, who is a subscriber to an ATS or a user of a QTRS. Since an Access Person is not handling “client orders”, an Access Person is subject to a limited subset of UMIR provisions (as noted above, these are principally related to open and fair practices, manipulative or deceptive methods of trade, improper orders and trades and short selling together with general trading requirements such as provisions related to order marking and order entry). If a Participant has provided certain of its clients with DMA or “dealer-sponsored access” to the trading system of a particular marketplace, the Participant must supervise and monitor the trading activity by such clients as the Participant is technically responsible for any breaches of UMIR as a result of this trading activity.

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39 Draft amendments to Regulation 23-101, s.s 7.6 and 8.4.

Proposed UMIR Amendments

Concurrent with the publication of this joint notice, RS has issued Market Integrity Notice 2007-009 - *Request for Comments – Provisions Respecting Access to Marketplaces* (April 20, 2007) that proposes amendments to the rules and policies under UMIR as a consequence of the draft amendments to Regulation 23-101 respecting "dealer-sponsored access" to a marketplace and the obligations of ATSs to monitor trading by subscribers and persons with "dealer-sponsored access". In particular, amendments to UMIR are being proposed to:

- provide a definition of "Dealer-Sponsored Access";

- establish requirements for a Participant to provide information to RS with respect to each person granted Dealer-Sponsored Access;

- extend the definition of:

    - "Access Person" to include any person (other than a dealer) to whom a Participant has granted Dealer-Sponsored Access, and

    - "Participant" to include a dealer to whom Dealer-Sponsored Access has been granted;

- require each Access Person to enter into an agreement with RS as a precondition to obtaining access to a marketplace;

- require each person entitled to enter orders on behalf of an Access Person on a marketplace to have met certain minimum proficiency standards respecting UMIR and other regulatory requirements governing the trading of securities on marketplaces; and

- establish certain trading supervision obligations for an ATS in respect of orders entered by a subscriber that is not a dealer.

D. Other Amendments

Other amendments that we have proposed to the ATS Rules and policy statements are summarized below:

1. Regulation 21-101

- drafting clarification regarding the definition of "foreign exchange-traded security"40

- amendments that include "representatives" in the definitions of "member", "user" and "subscriber"41

- drafting clarification regarding the record-keeping requirements for marketplaces (no change to the requirements in Part 11)42

- a requirement that a marketplace report material systems failures[43]

[40] Draft amendments to Regulation 21-101, s. 1.1.

[41] Draft amendments to Regulation 21-101, s. 1.1.

[42] Draft amendments to Regulation 21-101, s. 11.2.1.

- non-material housekeeping changes[44]

2. Regulation 23-101

- amendments that clarify that trading halts referred to are those imposed for a regulatory purpose45

- amendments to clarify that the jurisdiction of a regulation services provider extends to ATSs that cease to carry on business, and their former subscribers and dealer-sponsored participants with respect to conduct that occurred while the ATS, its subscribers or dealer-sponsored participants were subject to the requirements of the regulation services provider46

- drafting clarification for the record-keeping requirements for dealers and inter-dealer bond brokers (no change to the requirements implemented in December, 2006)[47]

IV. AUTHORITY FOR THE DRAFT AMENDMENTS

In those jurisdictions in which the draft amendments to the ATS Rules are to be adopted as a rule or regulation, the securities legislation in each of those jurisdictions provides the securities regulatory authority with rule-making or regulation-making authority in respect of the subject matter of the draft amendments to the ATS Rules.

V. COMMENTS AND QUESTIONS

We invite all interested parties to make written submissions with respect to the concepts described in this Joint Notice and amendments to the ATS Rules. Submissions received by July 19, 2007 will be considered.

You should send submissions to all of the CSA and to Market Regulation Services Inc.

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[43] Draft amendments to Regulation 21-101, s. 12.2.

[44] Draft amendments to Regulation 21-101, s. 1.1, Parts 7 and 8, s. 11.1 and s. 11.2.

[45] Draft amendments to Regulation 23-101, s. 5.1.

[46] Draft amendments to Regulation 23-101, s. 8.1(3).

[47] Draft amendments to Regulation 23-101, section 11.2.1.

Submissions to the CSA should be addressed in care of the OSC, in duplicate, as indicated below:

Alberta Securities Commission
British Columbia Securities Commission
Manitoba Securities Commission
New Brunswick Securities Commission
Securities Commission of Newfoundland and Labrador
Registrar of Securities, Department of Justice, Government of the Northwest Territories
Nova Scotia Securities Commission
Registrar of Securities, Legal Registries Division, Department of Justice, Government of Nunavut Ontario Securities Commission
Prince Edward Island Securities Office
Saskatchewan Financial Services Commission
Registrar of Securities, Government of Yukon

c/o John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
Suite 1900, Box 55
Toronto, Ontario M5H 3S8
e-mail: jstevenson@osc.gov.on.ca

Submissions should also be addressed to the Autorité des marchés financiers (Québec) as follows:

Madame Anne-Marie Beaudoin
Directrice du secrétariat
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, tour de la Bourse
Montréal, Québec H4Z 1G3
e-mail:consultation-en-cours@lautorite.qc.ca

Submissions to Market Regulation Services Inc. should be addressed to:

James E. Twiss
Market Regulation Services Inc.
Suite 900
145 King Street West
Toronto, Ontario
M5H 1J8
e-mail: jim.twiss@rs.ca

A diskette containing the submissions should also be submitted. As securities legislation in certain provinces requires a summary of written comments received during the comment period be published, confidentiality of submissions cannot be maintained.

Questions may be referred to any of:

Serge Boisvert
Autorité des marchés financiers
514-395-0558, ext. 4358

Shaun Fluker
Alberta Securities Commission
403-297-3308

Tony Wong
British Columbia Securities Commission
604-899-6764

Doug Brown
Manitoba Securities Commission
204-945-0605

Susan Greenglass
Ontario Securities Commission
416-593-8140

Randee Pavalow
Ontario Securities Commission
416-593-8257

Cindy Petlock
Ontario Securities Commission
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416-646-7277

APPENDIX A

Historical Market Structure Developments and Regulatory Responses

This section sets out the historical and current theories about how markets should be structured and the regulations that were introduced to promote the objectives that underlie those theories. As part of our analysis we have included changes in the U.S. that have influenced regulatory developments in Canada.

Each part in this section begins with an identification of:

- what was generally considered to be the ideal or preferred market structure (the "preferred market structure") which would achieve the desired values or objectives;

- the reasons or values determining the preferred market structure (the "objectives"); and

- any regulations that were implemented to support each objective ("how achieved").

We discuss the developments in market structure and regulatory responses as background to the changes being proposed. More specifically, the following sections will consider the evolution of market structure through changes brought about by industry and regulatory initiatives.

A. Historical perspective in Canada and the U.S., prior to 1970s

- Preferred market structure: single centralized marketplaces

- Objectives: price discovery and liquidity

- How achieved? via natural monopolies with restrictions in rules

Centralized exchanges for the trading of securities were seen as the most efficient type of marketplace. The reason was that bringing interested parties together both physically and temporally facilitated price discovery and liquidity (two important features of markets). These marketplaces were considered to be "natural monopolies" because the nature of listing and the limited access generally meant that trading in a security only took place at one venue. The fact that exchanges had listing rules and rules placing restrictions on where their participants could trade meant that trading remained centralized.

B. U.S. market developments - 1970s (National Market System)

- Preferred market structure: integrated marketplaces

- Objectives: price discovery, liquidity, competition and innovation

- How achieved? regulatory requirements including transparency and access; the creation of a National Market System (NMS) infrastructure for consolidation of market information and access between marketplaces (Consolidated Tape System, Consolidated Quotation System and Intermarket Trading System)

In early 1975, the U.S. Congress adopted the Securities Act Amendments (1975 Amendments) to deal with issues concerning the regional exchanges, significant growth in institutional trading and the impact of technology. The principal objective of the 1975 Amendments was to provide for "equally regulated, individual markets which are linked together to make their best price known and accessible."[48] The SEC believed that competition among marketplaces would allow greater investor choice and would encourage innovation. The NMS infrastructure ensured that all participants would have access to information regarding best bids and offers, that the national best bid and offer (NBBO) would be published, and all participants would have access to the NBBO for execution. The 1975 Amendments also provided the SEC with the authority to regulate and oversee information processors such as the Securities Industry Automation Corporation (SIAC). In addition, it required exchanges to remove rules which restricted their participants from trading on other marketplaces.

C. Development of ATSs and order handling rules

- Preferred market structure: integrated marketplaces
- Objectives: price discovery, liquidity, competition, innovation and market integrity
- How achieved? regulatory requirements regarding transparency (e.g. order handling rules), access with an additional focus on best execution but rejection of mandated consolidation and linkages in Canada

Developments of ATSs in the U.S. and market integrity issues on NASDAQ. From 1979 until the early 1990s, ATSs were developing in the U.S. and targeting institutional investors primarily for NASDAQ issues. In addition, there had been some studies and enforcement actions regarding the market makers on NASDAQ.[49] In 1996, the SEC announced new rules regarding the handling of retail orders in U.S. markets which required that dealers display all client limit orders better than the NBBO as part of their quote or through electronic communication networks (ECNs or ATSs). This requirement facilitated price discovery through greater transparency of orders. In 1998, the SEC published its final rules regarding the regulation of ATSs and set transparency and integration requirements for ATSs trading greater than 5% of the volume of an NMS security.

Instinet Hearings in Canada. The discussion of market structure issues began in Canada in 1989. They were first addressed by the OSC in the hearings on Instinet, an ATS, when the Commission decided Instinet should be admitted to TSE membership instead of allowing it to trade TSE securities outside of the TSE, and that the TSE should appoint a rule review committee to examine changes required to improve market quality and limit market fragmentation due to Instinet's inclusion. Instinet was restricted from installing terminals in Canada.

TSE Fragmentation Report and policy discussions. In January 1997, the TSE published a Report of the Special Committee on Fragmentation (Fragmentation Report). The Fragmentation Report concluded that consolidated markets provide the highest quality markets, but that it is not always possible to satisfy the needs of different participants with one market structure.

The public policy discussions considered the benefits and concerns brought about by having multiple marketplaces. The discussions also examined how new marketplaces provide competition and choice for investors regarding where to execute trades and how to execute them, while at the same time

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48 Securities and Exchange Commission Release No. 34-40760, "Regulation of Exchanges and Alternative Trading Systems", p.8.

49 Christie and Schultz, The Journal of Finance (1994).

the development of multiple marketplaces can cause fragmentation of the price discovery process and market surveillance.

The CSA considered the recommendations made in the Fragmentation Report, recognizing that regulators should continue to promote innovation and competition while establishing fair and equitable practices, when contemplating a solution to market structure issues. The issue was addressed in 1999, as part of the Proposals on Alternative Trading Systems.[50]

Exchange Restructuring. Also in 1999, the existing exchanges (TSE, ME, VSE and ASE[51]) entered into an agreement whereby each exchange would specialize and none would compete for a period of ten years. Specifically, the TSE became the senior equities exchange, the VSE and ASE merged to form CDNX for junior equities and the ME became the derivatives exchange.

2001 ATS Rules transparency, data consolidation and market integration requirements. As noted above, the purpose of the ATS Rules adopted in December, 2001, was to create a framework that permits competition between traditional exchanges and other marketplaces, while ensuring that trading is fair and efficient. This was to be achieved by:

- Providing investor choice as to execution methodologies or types of marketplaces;
- Improving price discovery;
- Decreasing execution costs; and
- Improving market integrity.

This was especially important given the restructuring of the exchanges and the result that there would be no interlisting of securities.

The ATS Rules imposed transparency, consolidation and integration requirements for orders and trades of exchange-traded securities and unlisted debt securities. In addition, the rules contained provisions on best execution, fair access, and prohibition against manipulation and fraud to strengthen market integrity across all marketplaces.

2003 Amendments – removal of consolidation and integration requirements. In 2003 the ATS Rules were amended to delete the concept of a data consolidator and market integrator for equity securities to promote a market-driven solution to consolidation in the equity markets. This was based on the theory that best execution would require market participants to generally trade at the best prices – whether directly or through another market participant – and that access to data, which was supported by the transparency requirements, would facilitate market-driven consolidation. At the time, there were no ATSs trading in Canadian-only listed securities and the CSA agreed with the views of an industry committee that we should wait and monitor developments in the marketplace before imposing the costs of creating a consolidator.

2005 Amendments – re-emergence of multiple marketplaces in Canada. With the first ATS trading Canadian listed securities, it was time to revisit the market structure issues and solutions.

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50 The original rules set out requirements for market integration as well as data transparency.

51 The WSE did not participate in the agreement, but later became part of the entity formed by the merger of the VSE and ASE – CDNX.

Cost-benefit Analysis

Proposed Amendments to National Instrument 21-101 *Marketplace Operation* and National Instrument 23-101 *Trading Rules*

1) Introduction

The Canadian Securities Administrators (CSA) are proposing amendments to National Instrument 21-101 *Marketplace Operation* (NI 21-101) and National Instrument 23-101 *Trading Rules* (NI 23-101). The proposed amendments cover two areas:

a) Best execution

i) Acknowledging in the rule that advisers managing a client's portfolio have a best execution obligation to their clients. When acting for their client, advisers must make reasonable efforts to achieve best execution.

ii) Broadening best execution beyond "best execution price" in NI 23-101. Best execution would be defined as "the most advantageous execution terms reasonably available under the circumstances".

iii) Dealers would be required to report order execution statistics and marketplaces would report market quality information. Additionally, dealers would be required to disclose any material aspects of a dealer's relationship with a particular marketplace.

b) Non-dealer market access

Currently non-dealer ATS subscribers are subject to a subset of Universal Market Integrity Rules (UMIR) provisions while direct market access (DMA)[52] clients are not subject to UMIR[53]. Non-dealer participants would be subject to UMIR provisions regardless of whether they are an ATS subscriber or a DMA client of an investment dealer. Additionally, it is proposed that DMA clients and ATS subscribers sign an agreement with the applicable regulation service provider to ensure compliance with the rules. To ensure that representatives of these market participants are knowledgeable about the rules, they would be required to first successfully complete an examination relating to an industry-approved training course (e.g. Canadian Securities Institute's Trader Training course).

This cost-benefit analysis (CBA) will focus on the proposed introduction of market quality and execution statistics as it would involve technology and infrastructure costs for investment dealers and marketplaces. The other changes in the proposed amendments would cause participants to

[52] "Direct market access" are clients with direct intermediated access (i.e., through or "sponsored by" a dealer) to an exchange or ATS. Subscribers have direct access to an ATS.

[53] The dealer must monitor and supervise the trading of their DMA accounts as they are still technically responsible for any UMIR breaches.

make changes to their policies and procedure but these are unlikely to involve significant costs and are likely to be predominantly one-time costs.

2) The Issue

The CSA are updating the requirements in NI 21-101 and NI 23-101 to reflect market structure developments. Although these National Instruments have allowed for a security to be traded on more than one marketplace, that situation has only recently become a reality. This leads to a number of issues:

(a Dealers are required to reasonably provide best execution. In the absence of marketplace statistics, dealers are missing an important tool for determining the most suitable marketplace for their client.

(b Investors may be constrained in their ability to monitor how trades are executed. A standardized set of execution statistics would allow investors to make comparisons and more informed investing decisions.

c) All marketplaces have an incentive to maintain or improve their market share. In the absence of standardized disclosure, marketplaces may make available the most favourable statistics and so comparisons between marketplaces may be difficult if not impossible. A standardized set of statistics will enable participants to compare the quality of individual marketplaces and make more informed order routing decisions.

In effect, there is an information asymmetry[54] issue; intermediaries are unable to comprehensively evaluate the service they receive from a marketplace and investors are limited in their ability to evaluate their intermediaries. As a result, regulation may be required to address the issue.

3) Outcome

The market quality and order execution statistics in the proposed amendments should help:

(a Foster a competitive environment for marketplaces;

(b Promote better informed trading and compliance with fiduciary obligations and rule requirements through order execution and marketplace quality statistics; and

(c Investors determine which dealer would best suit their needs given order routing dealer statistics.

4) Background

The December 2001 adoption of NI 21-101 and NI 23-101 established a framework for competition between traditional exchanges and other marketplaces while ensuring that trading is fair and efficient. Obtaining the best terms available is rarely an issue for investors when a

[54] Information asymmetry occurs when relevant information is known to some but not all market participants. This prevents markets from operating efficiently as some market participants are unable to make fully-informed decisions.

security trades on a single marketplace. That single marketplace structure guarantees best price, which for most retail investors is the best terms available.

In a multiple marketplace environment, providing clients with the most advantageous execution terms reasonably available under the circumstances becomes more complicated. Dealers may also need to consider execution speed, price, overall transaction cost, and order fill certainty[55].

Evaluating best execution

In order for market participants to ensure they are achieving the most advantageous execution terms available, they need to be able to make informed choices about how well their dealer meets its best execution obligation and which marketplaces are used to execute their transactions. In a multiple marketplace environment, most retail investors are unlikely to have the sophistication or infrastructure available to determine whether their dealer is providing them with best execution. They are also unable to determine which dealer(s) suit their needs. To help investors make better decisions, dealers should provide investors with accessible data on their order routing decisions. The CSA propose that such information would include the percentage of orders that were directed to a marketplace without specific routing instructions, whether there are any material agreements between the dealer and marketplace, and the marketplaces available.

In order for a dealer to provide best execution to clients, it must have a process for analysing the marketplaces where a security trades and data upon which to base execution decisions. This information is more consistent and measurable if marketplaces provide standardized periodic and timely order execution quality statistics.

5) Alternatives

Given the above identified issues, we have identified three alternative policy responses: (a) implement the CSA's proposed order execution and market quality statistics; (b) proceed with no reporting requirements (status quo); or (c) implement proposed order execution and market quality statistics as specified in a) and also include marketplace spread statistics, as required in SEC Rule 605.

a. Implement the CSA's proposed order execution and market quality statistics

As proposed, marketplaces would be required to provide, on a monthly basis, market quality statistics which would include:

i) Liquidity measures (e.g. the number of orders that the marketplace received, cancelled, and executed)

ii) Trading statistics (e.g. the volume and value of all trades on marketplace, average trade size, and the number of trades of a given size)

iii) Speed and certainty of execution measures (e.g. the number of orders at the best bid price and best ask price of the marketplace executed within certain time ranges)

The information in i) to iii) would be categorized by security and, order type. For more detailed information on these statistics, refer to Part 14.1 of the proposed amendments to NI 21-101.

[55] As discussed in the introduction, the proposal would amend the "best execution price" since in today's environment, investors may demand speed, order execution certain, and transaction cost, in addition to price.

Dealers would be required to provide quarterly statistics on order routing. The proposed CSA reporting requirements for dealers are similar to the SEC rule. These include the percentage executed at a location determined by the dealer, the identity of marketplaces and the percentage of orders routed to each marketplace, and the disclosure of material arrangements with any marketplace. Also, upon request, a dealer would be required to disclose to its client the identity of the marketplace where the client's orders were routed for execution in the six months prior to the request, whether the dealer was specifically instructed to route to a particular marketplace for execution and the time of the transactions, if any, that resulted from such orders.

Costs

- Although marketplaces already maintain records of orders received and trades executed, they would realize incremental costs associated with manipulating the raw data into the required statistics. This would include software and systems costs associated with the manipulation and resources devoted to ensuring the integrity of the marketplace statistics. Alternatively, service providers may emerge to generate and report these statistics on behalf of a marketplace for a fee, as has occurred in the U.S.

- Dealers are already likely to keep track of the client orders, the associated routing instructions, and the details of how the order was routed and so there should be limited data acquisition costs. However, that information will have to be stored in a way that is accessible on-demand, and can be manipulated into aggregate reports or reports for an individual client. As a result dealers may incur costs associated with changing how this information is stored and implementing reporting tools.

- A new marketplace's ability to attract liquidity may be hampered by published marketplace statistics. The statistics may reinforce that new entrants often have a limited ability to attract liquidity.

- Dealers would also incur costs related to ensuring the integrity of published execution statistics. The publication of incorrect information could pose a risk to a firm's reputation.

- Misinterpreted order routing statistics may result in frivolous lawsuits; clients might claim their dealer is not meeting their best execution requirement[56]. This may be compounded by the fact that dealers cannot always execute trades exactly as the client would like.

Benefits

- Marketplace quality statistics provide guidance to dealers to help meet their best execution obligation[57].

- Increased information about marketplace quality enables traders to develop more advanced routing algorithms with the aim of decreasing trading costs for clients.

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[56] See Morgan Stanley Dean Witter & Co's comment letter to SEC regarding the proposed disclosure of order-routing and execution practices rule. September 25, 2000. Source: http://www.sec.gov/rules/proposed/s71600/roger1.htm

[57] In a recent study of the US market, it was found that marketplace statistics influence a dealer's order routing decisions. The marketplaces that provided fast execution and lower execution costs received more order flow. This paper also provided anecdotal evidence of companies claiming to use the dealer statistics. Source: Boehmer, E., and Jennings, R, and Wei, L, "Public Disclosure and Private Decisions: Equity Market Execution Quality and Order Routing" (2006), Review of Financial Studies (forthcoming).

- The combination of dealer order routing information and marketplace quality statistics would allow investors to become more informed about execution options.

- A uniform set of marketplace quality statistics would enable participants to objectively compare marketplaces. Participants would be able to determine if a marketplace has a comparative advantage in a specific area (e.g. speed, order fill rates, etc) and this would encourage competition between marketplaces. The statistics could also help new marketplaces identify underserved segments of the market.

- Order routing decisions and client trade data might help investors determine whether their dealer is obtaining best execution[58]. Investors would also be in a better position to be able to compare the order routing practices of different dealers. Some investors may lack the knowledge to be able to interpret the order routing and marketplace quality statistics. However, other stakeholders may interpret and communicate the relevant facts to such individuals[59].

b. Proceed with no reporting requirements (status quo)

Under the status quo, the market would continue to develop and securities would trade on multiple marketplaces while there would be no order execution and market quality statistics requirements.

Costs

- As the number of marketplaces grows, investors and intermediaries would find it increasingly difficult to evaluate the different execution options.

- Without greater knowledge, investors would not be able to meaningfully measure the execution achieved by their dealer.

- Although some dealers and marketplaces may choose to report certain information there would be no requirement for standardized statistics. Market quality information is only beneficial if all marketplaces provide it and participants are able to make better informed decisions. Investors can only use order execution information to make informed decisions if it is available from all dealers and is comparable.

Benefits

- There would be no additional costs to dealers or marketplaces.

- There is little additional benefit for investors.

c. Implement proposed order execution and market quality statistics as specified in a) and also include marketplace spread statistics, as required in SEC Rule 605.

[58] Investors would also have to consider brokerage fees, service requirements, and other features which are not captured in these statistics.

[59] This was a criticism of the SEC's proposal but the SEC anticipated that this would not be an issue since "independent analysts, consultants, broker-dealers, the financial press, and market centers would analyze the information and produce summaries that respond to the needs of investors". Source: http://www.sec.gov/rules/final/34-43590.htm

The SEC's marketplace statistics also include measure of the average effective and average realized spreads which are reported on a monthly basis[60]. These spread statistics are intended to provide an estimate of how well a marketplace offers price improvement and liquidity, respectively, on a given security[61]. Since the CSA are soliciting feedback on whether these spread statistics should be included, this section examines the potential costs and benefits of these figures.

In order to calculate the average effective and realized spread, a marketplace would need to compare the transaction price with the best bid and offer across all marketplaces. Each individual marketplace could calculate the best bid and offer across all marketplaces or, if commercially viable, a single information processor may provide this service.

Alternatively, the effective and realized spread could be calculated using the individual marketplace's best quoted bid and ask. These statistics would be considerably less informative and some marketplaces would be unable to produce usable statistics because limited liquidity can mean that there is no two-sided market for a security.

Costs

- Costs associated with alternative (a) also apply to (c)
- Given the complexity of effective and realised spread statistics, marketplaces would likely incur higher costs than the current proposed amendments
- In order to calculate the spread, marketplaces would have to get data from an information processor (if available) or directly from other marketplaces. Some marketplaces may, as part of their business model, need access to the best bid and offer across all marketplaces.

Benefits

- The benefits of alternative (a) also apply to (c)
- If marketplace spread statistics are introduced, they can be used to conduct transaction cost analysis (difference between bid/ask spread on round-trip trade, etc).
- Although more costly to implement, marketplaces could offset some of the cost by selling transaction cost analysis tools back the marketplace participants
- Participants would be better able to assess the liquidity risk of a particular security.

[60] The US requires spread calculations for each security by order size (ranges) and order type.

The average effective spread measures the distance between the midpoint of the market at the time an order is entered and the execution price received. This value is then doubled to incorporate the whole bid/ask spread.

The average realized spread measures the execution price to the midpoint of the national best bid and ask 5 minutes after the order is entered.

[61] Aggregated marketplace statistics may be subject to selection bias for markets that specialize in smaller stocks, trade more volatile stocks, or trade difficult order flow (e.g. knowledgeable investors that trade large blocks). See Bessembinder H, "Selection Biases and Cross-Market Trading Cost Comparisons" (2003), Working Paper.

- The addition of marketplace spread statistics would further improve a dealer's ability to make trading decisions that would be most beneficial to their clients.

6) Conclusions

More informed industry participants would improve the efficiency and fairness of Canada's capital markets. On that basis, the introduction of order routing and market quality statistics is more desirable than continuing with the status quo.

On a qualitative basis there is reason to believe that the introduction of order execution and market quality statistics would be beneficial. At this stage there is very little available information about how these statistics may be used in the Canadian market and the likely cost of producing them. Without that data it is difficult to make assess the relative costs and benefits of options (a) and (c) above.

As such, the OSC will survey investment dealers, marketplaces, and other market participants to collect quantitative estimates of the cost and benefits or order execution and market quality statistics. We will begin surveying during the spring of 2007. The results of that survey will be published in a revised CBA.

7) Additional request for comments

Do you believe there are any other costs to implement best execution reporting that are not covered by this CBA?

If you wish to participate in CBA discussions on the best execution reporting requirements, please contact:

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