

## Notice of publication

### *Regulation to amend Regulation 21-101 respecting Marketplace Operation*

### *Regulation to amend Regulation 23-101 respecting Trading Rules*

## I. Introduction

The Canadian Securities Administrators (the CSA or we) have made amendments (Amendments) to the following regulations:

1. *Regulation 21-101 respecting Marketplace Operation* (“Regulation 21-101”) and *Policy Statement to Regulation 21-101 respecting Marketplace Operation* (“Policy Statement 21-101”); and
2. *Regulation 23-101 respecting Trading Rules* (“Regulation 23-101”) and related *Companion Policy 23-101 Trading Rules* (“23-101CP”).

The amendments to Regulation 23-101 deal mostly with the best execution obligation of dealers and advisers.

In Ontario, the Amendments were delivered by the Ontario Securities Commission (OSC) to the Minister of Finance for approval on June 20, 2008. Subject to Ministerial consideration, the Amendments will come into force on September 12, 2008.

## II. Background

These Amendments were initially published for comment along with other draft amendments on April 20, 2007 with the *Joint Notice on Trade-Through, Best Execution and Access to Marketplaces* (Joint Notice).<sup>1</sup> The Joint Notice, published in conjunction with Market Regulation Services Inc. (RS), now the Investment Industry Regulatory Organization of Canada (IIROC), proposed rule amendments relating to best execution and access to marketplaces. In addition, the Joint Notice outlined a proposal for a trade-through protection regime.

Because these three topics are separate and distinct and there are different issues associated with each one, we have decided to deal with trade-through, best execution and access to marketplaces separately and on different timetables. At this time, we are proceeding with the draft rule and policy changes dealing with best execution along with some other changes, including one related to the electronic audit trail provisions. We intend to propose amendments dealing with trade-through protection and rules related to access to marketplaces by issuing separate requests for comment in the coming months.

We received nineteen comment letters in response to the request for comments published in April 2007. We have considered the comments received and thank all commenters for their submissions. A list of those who submitted comments, as well as a summary of comments pertaining to best execution and our responses to them, are attached as Appendix A to this Notice.

### I. Best Execution

At this time, the CSA are publishing the Amendments dealing with best execution in their final form.

Based on the feedback to Concept Paper 23-402 *Best execution and soft dollar arrangements*<sup>2</sup>, the CSA proposed changes in April 2007 to the best execution requirements in Regulation 23-101, which are consistent with existing obligations in the

<sup>1</sup> Bulletin de l'Autorité, Vol. 4, No. 16, 2007-04-20.

<sup>2</sup> Bulletin de l'Autorité, Vol. 2, No. 5, 2005-02-04.

Universal Market Integrity Rules (UMIR). At the same time, IIROC, then RS, proposed parallel amendments to the best execution obligations outlined in the rules and the related policies under UMIR.

The changes proposed by the CSA created a definition of best execution and imposed a best execution obligation that requires dealers and advisers to use reasonable efforts to achieve best execution. The draft changes to 23-101CP clarified that the obligation of best execution goes beyond price to include other elements such as:

- speed of execution,
- certainty of execution, and
- the overall cost of the transaction.

The draft changes to 23-101CP also clarified that the application of the best execution definition will vary depending on the specific circumstances, and also, on who is responsible for obtaining best execution. Part 4 of 23-101CP also reiterates that where a security trades on multiple marketplaces, it does not 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 the security is traded.

Since publication in April 2007, we have clarified some of the language in Regulation 21-101 and Regulation 23-101 and the related policy statements concerning best execution, with no substantive or material changes to the draft amendments published with the Joint Notice. Specifically, we have clarified that:

- A dealer is required to make reasonable efforts to use facilities providing information regarding orders and trades to satisfy the “reasonable efforts” test for the best execution obligation.<sup>3</sup>
- To achieve best execution, a dealer or adviser should be able to demonstrate that it has abided by its best execution policies and procedures. We have further explained that these policies and procedures should describe how the dealer or adviser evaluates whether best execution was obtained and should be regularly and rigorously reviewed.<sup>4</sup>
- Policies and procedures for seeking best execution should include the requirement to evaluate whether taking steps to access orders on a specific marketplace is appropriate under the circumstances.<sup>5</sup>
- Dealers should include in their best execution policies and procedures a regular assessment of whether it is appropriate to consider ATSS in Canada that trade foreign exchange-traded securities as well as the foreign markets upon which these securities trade.<sup>6</sup>

We have decided to postpone the implementation of the draft best execution reporting requirements for marketplaces and dealers due to intervening market developments. We intend to republish these draft amendments and when we do, we will include a discussion of the comments received in response to the Joint Notice and our responses. We note by way of summary, however, that commenters were generally supportive of the draft reporting requirements. There were some mixed views on specific aspects of the reporting requirements, such as spread-based statistics and securities traded on only one marketplace. Comment letters received have been posted on the OSC website ([www.osc.gov.on.ca](http://www.osc.gov.on.ca)).

<sup>3</sup> Amendments to s. 4.3 of Regulation 23-101 and ss. 4.1(8) of 23-101CP.

<sup>4</sup> Amendment to ss. 4.1(3) of 23-101CP.

<sup>5</sup> Amendment to ss. 4.1(5) of 23-101CP.

<sup>6</sup> Amendment to ss. 4.1(6) of 23-101CP.

IIROC will be publishing a notice regarding its proposed amendments to UMIR relating to best execution shortly. These UMIR amendments are expected to come into force on September 12, 2008.

## **2. Trade-through Protection**

The Joint Notice proposed a framework for trade-through protection that would place an obligation on marketplaces to protect all visible, better-priced orders that are immediately and automatically executable. For additional information, please refer to the Joint Notice.

Commenters were largely supportive of the framework for a trade-through rule at the marketplace level that extended to the full depth-of-book. Consequently, the CSA intend to obtain feedback by publishing for comment draft amendments to Regulation 23-101 introducing trade-through protection in the coming months. A full summary of comments and CSA responses pertaining to the trade-through proposal will be published at that time.

## **3. Regulation of Sponsored Access to Marketplaces**

Also published with the Joint Notice were changes that proposed additional requirements on access by “dealer-sponsored” participants to marketplaces (i.e. direct market access). For additional information on the draft amendments relating to access, please refer to the Joint Notice and related draft amendments to Regulation 23-101.

At the same time, IIROC, then RS, published proposed amendments to the UMIR in order to be consistent with the draft CSA changes. In response to comments received, the CSA and IIROC are examining the draft amendments and intend to re-publish a revised proposal for comment. The full summary of comments and CSA responses pertaining to the regulation of access to marketplaces will be published at that time. Commenters were generally supportive of the training requirements for dealer-sponsored participants. However, they expressed concern about requiring clients to sign an agreement with the regulation services provider. The CSA, in revising the proposal, will take these comments into account.

## **4. Electronic Audit Trail**

Part 11 of Regulation 23-101 imposes obligations on dealers and inter-dealer bond brokers to record and report in electronic form certain information regarding orders and trades. Amendments have been made to Part 11 of Regulation 23-101 and the related Part 8 of 23-101CP that clarify the record keeping requirements for dealers and inter-dealer bond brokers with no substantive changes being made to the underlying electronic trail requirements.

The draft amendments published in April 2007 included a reference to the implementation of a specified “electronic form” by the securities regulatory authority, regulation services provider or self-regulatory entity (i.e. the TREATS initiative). This reference has not been included in the Amendments. We have also removed the reference to the intended implementation date (January 1, 2010). We will be publishing a joint notice with the self-regulatory organizations that provides an update on the current status of the TREATS initiative and the proposed next steps.

## **5. Other Changes**

The Amendments also include:

- (a) minor changes to the definitions of “foreign exchange-traded security”, “member”, “recognized exchange”, “subscriber” and “user”<sup>7</sup>;

<sup>7</sup> Amendments to s. 1.1 of Regulation 21-101.

- (b) changes to Parts 7 and 8 of Regulation 21-101 to ensure consistency<sup>8</sup>; and
- (c) changes to require ATSS to report material systems failures<sup>9</sup>.

We have left the references relating to the information vendor in Parts 7 and 8 of Regulation 21-101 as they currently exist. Specifically, the references to the “standards set by the regulation services provider” have not been removed. We will re-examine this decision in the context of the trade-through protection proposal.

### III. Questions

Questions may be referred to any of:

Serge Boisvert  
Autorité des marchés financiers  
514-395-0337, ext. 4358

Tracey Stern  
Ontario Securities Commission  
416-593-8167

Sonali GuptaBhaya  
Ontario Securities Commission  
416-593-2331

Susan Greenglass  
Ontario Securities Commission  
416-593-8140

Lorenz Berner  
Alberta Securities Commission  
403-355-3889

Doug Brown  
Manitoba Securities Commission  
204-945-0605

Tony Wong  
British Columbia Securities Commission  
604-899-6764

For specific questions on the electronic audit trail:

Norm Leonard  
Ontario Securities Commission  
416-593-2307

<sup>8</sup> Amendments to s. 7.5, 8.3 and 8.5 of Regulation 21-101.

<sup>9</sup> Amendment to s. 12.2 of Regulation 21-101.

## Appendix A

### Summary of Comments with CSA Responses and List of Respondents

#### I. Summary of Comments to Questions and CSA Responses

<b>Question 15: Are there other considerations that are relevant?</b>	
<i>Comments</i>	<i>CSA Responses</i>
<p>Four commenters stated that they believe the key elements of best execution were correctly identified in the Joint Notice and sufficiently cover the considerations related to best execution.</p> <p>The following additional considerations were suggested by commenters:</p> <ul style="list-style-type: none"> <li>• anonymity;</li> <li>• the overall cost factor should include information leakage costs and systems costs of having to split a trade into multiple transactions and then reconstituting it;</li> <li>• consideration of risk management; and</li> <li>• overall portfolio goals.</li> </ul> <p>A few commenters suggested a principle-based best execution rule where dealers can demonstrate that the objectives of their clients are being met through documented policies, procedures, and practices. Some commenters called for specific guidelines as to how to systematically achieve best execution for clients and how to manage the investment process to minimize potential conflicts of interest.</p> <p>One commenter requested clarification regarding commission rates that encompass investment decision-making services used by an adviser with the objective of maximizing a client's portfolio value in view of best execution, and suggested 23-101CP should include fees in order to address the benefits of permitted investment decision-making services (research).</p>	<p><i>We believe that it is important to retain a very broad description to allow dealers the necessary flexibility to make the assessment of best execution.</i></p> <p><i>The definition requires an assessment of the "most advantageous execution terms reasonably available under the circumstances". The list of elements identified in 23-101CP that may be considered in seeking best execution is not exhaustive, but the CSA have identified four key elements (i.e. price, speed of execution, certainty of execution and overall cost of the transaction) that should be considered. In addition, these four elements are broad and may encompass more specific considerations.</i></p> <p><i>Best execution is a principles-based obligation. We are of the view that specific guidelines would unfairly constrain dealers and advisers from assessing what steps are necessary to comply.</i></p> <p><i>Draft Regulation 23-102 respecting Use of Client Brokerage Commissions as Payment for Order Execution Services or Research Services would require an adviser to make a good faith determination that the commission paid is reasonable in relation to the value of goods and services received. Services included in a commission payment may be evaluated in light of the overriding duty of best execution.</i></p>
<b>Question 16: How does the multiple marketplace environment and broadening the description of best execution impact small dealers?</b>	
<i>Comments</i>	<i>CSA Responses</i>
<p>The majority of commenters that responded to this question believe that a multiple marketplace environment will place a great financial burden on smaller dealers, in part through increased costs of technologies to route orders, as well as compliance costs.</p> <p>However, another commenter contended that best</p>	<p><i>We recognize that the introduction of multiple marketplaces affects all dealers with respect to the way they meet their best execution obligation. The changes to best execution confirm the current obligations imposed on all dealers that are marketplace participants (dealer that is a member of an exchange, a user of a quotation and trade reporting system or a subscriber of an ATS) by UMIR.</i></p>

<p>execution is easily achievable for small dealers since trade access vendors have built solutions to provide smart routing of orders and small dealers are not required to build costly technology solutions.</p> <p>Finally another commenter remarked that broadening the definition of best execution will be beneficial to smaller dealers in that they will be allowed to pursue niche strategies that target the needs of a specific client class and increase the number of execution options/strategies to investors. This commenter suggested that the impact of multiple marketplaces on small dealers can be mitigated through the interconnection of marketplaces and by applying a de-minimis standard so that these dealers will only need to contemplate marketplaces that have attained a significant presence in the market.</p>	<p><i>For those dealers that are not marketplace participants and access marketplaces through another dealer, a broader best execution obligation enables them to take more factors into account.</i></p>
<p><b>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?</b></p>	
<i>Comments</i>	<i>CSA Responses</i>
<p>Five commenters were of the view that there should be no difference in the best execution obligation for an adviser who retains control over trading decisions.</p> <p>Four commenters stated that there is no reason to impose best execution requirements on the adviser. Some of these commenters cited that the best execution obligation for an adviser should remain on a portfolio basis because it is better aligned with an adviser's objective to maximize a client's overall portfolio value.</p> <p>A couple of commenters were of the view that the dealers that execute transactions for advisers should remain responsible for the best execution of their clients' orders.</p>	<p><i>The inclusion of advisers is a codification of existing obligations applicable to advisers. 23-101CP indicates that the considerations may be different for advisers than for dealers and only provides some high level principles. In addition, if an adviser directly accesses a marketplace, then the factors applicable to dealers may also apply.</i></p> <p><i>If an adviser accesses marketplaces using "dealer-sponsored access", the adviser maintains its best execution obligation to its clients and the dealer providing the direct market access has the best execution obligation to its client, the adviser.</i></p>
<p><b>Question 18: Are there any other areas of cost or benefit not covered by the CBA?</b></p>	
<i>Comments</i>	<i>CSA Responses</i>
<p>Commenters suggested the following points be considered in the CBA:</p> <ul style="list-style-type: none"> <li>• The cost and time that dealers incur in order to ensure that they are able to connect to the markets;</li> <li>• The costs of implementation (i.e. development/data storage) separately from the costs of collecting and maintaining the data; and</li> <li>• The costs incurred by dealers will be passed on to advisers and smaller advisers may be more</li> </ul>	<p><i>Dealers are likely to incur costs when connecting to marketplaces. However, the costs are related to market-driven changes and are not incremental costs arising from the draft amendments. As such they are beyond the scope of the cost-benefit analysis.</i></p>

affected as they do not have the same economies of scale as larger advisers.	
<p><b>General Comments</b></p> <p>One commenter suggested that having dealers consider all marketplaces within and outside of Canada in making a best execution analysis is too broad and that the requirement should be refined to apply to situations where a dealer is currently accessing the foreign market.</p> <p><i>Requests for Clarification</i></p> <p>Further clarity on the following was requested:</p> <p>Whether a market participant's "best execution" obligation (which is primarily driven by obtaining the "best price") is consistent with the participant's trade-through obligations under the definition provided by the CSA.</p> <p>What is the "consolidated market display", who is going to provide it, is there going to be a charge for this service and how is the consolidated market display going to be provided to the public?</p>	<p><i>We note that the obligation with respect to considering all marketplaces, whether within or outside Canada, currently exists. The Amendments merely clarify the language of the existing obligation.</i></p> <p><i>A market participant's best execution obligation must operate in tandem with its trade-through obligation. The decision of how and where to trade is determined by the particulars of the order and needs of the client but all best-priced orders must be dealt with at the time of execution. When draft amendments are published dealing with trade through protection, in order to ensure these concepts work together, we will propose certain tools that allow different trades to be carried out simultaneously.</i></p> <p><i>The CSA are currently examining applications to be the information processor. For more information, see CSA Staff Notice 21-306 Notice of Filing of Forms 21-101F5 Initial Operation Report for Information Processor published on April 20, 2007.<sup>10</sup></i></p>

## II. List of Respondents

1. Bloomberg Tradebook Canada Company
2. BMO Financial Group
3. Canadian Security Traders Association Inc.
4. CNQ
5. CPP Investment Board
6. egX Canada
7. Highstreet Asset Management Inc.
8. Investment Industry Association of Canada
9. ITG Investment Technology Group
10. Liquidnet Canada Inc.
11. Merrill Lynch Canada Inc.
12. Perimeter Markets Inc.
13. Raymond James Ltd.
14. RBC Asset Management Inc.
15. RBC Dominion Securities Inc.
16. Scotia Capital Inc.
17. TD Asset Management Inc.
18. TD Newcrest
19. TSX Group Inc.

<sup>10</sup> Bulletin de l'Autorité, Vol. 4, No. 16, 2007-04-20.