

Chapter 13

SRO Notices and Disciplinary Proceedings

13.1.1 RS Notice - Request for Comments – Proposed UMIR Regulation Fee Model

January 12, 2007

No. 2007-001

RS NOTICE

REQUEST FOR COMMENTS

PROPOSED UMIR REGULATION FEE MODEL

This RS Notice provides notice that the Board of Directors of Market Regulation Services Inc. has approved a new model to recover RS's costs of providing UMIR regulation services to marketplaces for which RS is the regulation services provider.

The proposed fee model will, through the application of activity-based costing principles, ensure that the fees RS charges to provide UMIR regulation to marketplaces reflect RS's costs of providing that service more accurately than RS's current UMIR regulation fee model.

Questions / Further Information

For further information or questions concerning this notice contact:

Doug Harris
Director of Policy, Research and Strategy
Telephone: 416.646.7275 / Fax: 416.646.7265
e-mail: doug.harris@rs.ca

PROPOSED UMIR REGULATION FEE MODEL

Summary

This RS Notice provides notice that the Board of Directors ("Board") of Market Regulation Services Inc. ("RS") has approved a new model (the "Proposed Fee Model") to recover RS's costs of providing UMIR regulation services to marketplaces for which RS is the regulation services provider.

The Proposed Fee Model will, through the application of activity-based costing principles, ensure that the fees RS charges to provide UMIR regulation to marketplaces reflect RS's costs of providing that service more accurately than RS's current UMIR regulation fee model.

If the recognizing regulators approve the Proposed Fee Model, RS will implement the Proposed Fee Model as soon as possible thereafter.

RS is developing a further proposal in relation to the costs to consolidate marketplace regulatory data and to develop displays and tools to provide effective cross-market monitoring. This further proposal is still subject to RS Board review and approval, and so will be published separately.

Approval Process

RS has been recognized as a self-regulatory organization by the Alberta Securities Commission, British Columbia Securities Commission, Manitoba Securities Commission, Ontario Securities Commission and, in Quebec, by the Autorité des marchés financiers (the "Recognizing Regulators") and, as such, is authorized to be a regulation services provider for the purposes of the National Instrument 21-101 and National Instrument 23-101.

Section 2(b)(ii) of RS's recognition order provides that RS will not, without prior Recognizing Regulator approval, make any significant changes to its fee model. RS has requested Recognizing Regulator approval of the Proposed Fee Model.

The Proposed Fee Model will be effective as soon as possible after approval by the Recognizing Regulators following public notice and comment. Comments on the Proposed Fee Model should be in writing and delivered by **February 12, 2007** to:

Doug Harris
Director of Policy, Research and Strategy
Market Policy and General Counsel's Office
Market Regulation Services Inc.
Suite 900
145 King Street West
Toronto, Ontario M5H 1J8

Fax: 416.646.7265
e-mail: doug.harris@rs.ca

A copy should also be provided to the Recognizing Regulators by forwarding a copy to:

Cindy Petlock
Manager, Market Regulation
Capital Markets Branch
Ontario Securities Commission
Suite 1903, Box 55
20 Queen Street West
Toronto, Ontario. M5H 3S8

Fax: (416) 595-8940
e-mail: cpetlock@osc.gov.on.ca

Commentators should be aware that a copy of their comment letter will be publicly available on the RS website (www.rs.ca under the heading "Market Policy"). A summary of the comments contained in each submission will also be included in a future RS Notice dealing with the revision or the approval of the Proposed Fee Model.

Background to the Proposed Fee Model

Current RS UMIR Regulation Fee Model

RS currently charges fees for two types of services:

- the administration of UMIR: RS's costs of providing this service are recovered from marketplaces or the persons with trading access to the marketplaces, based on trading activity; and
- services other than the administration of UMIR (such as the provision of investigative research in connection with the listing of issuers on an exchange and the provision of timely disclosure services in accordance with the requirements of an exchange): RS's costs of providing these services are recovered directly from the marketplace to which the service is provided, based on the cost of providing such services.

The Proposed Fee Model relates solely to RS's recovery of its costs for the administration of UMIR, and does not relate to its provision of other services.

To recover the costs related to the administration of UMIR, RS currently assesses the UMIR regulation fee on all trades executed on marketplaces for which RS is the regulation services provider. Presently, RS has been retained to be the regulation services provider for the Toronto Stock Exchange ("TSX"), TSX Venture Exchange ("TSXV") and Canadian Trading and Quotation System ("CNQ"), each as a recognized exchange ("Exchange"), and for Bloomberg Tradebook Canada Company, Liquidnet Canada Inc., Perimeter Markets Inc., Shorcan ATS Limited and TriAct Canada Marketplace LP, each as an alternative trading system ("ATS"), and Pure Trading, a facility of CNQ.

RS currently collects the UMIR regulation fee from:

- each ATS that has retained RS as its regulation services provider; and
- each Participant.¹

¹ Capitalized terms not otherwise defined in this Notice have the meanings attributed to them in UMIR.

RS's current UMIR regulation fee is uniform across all marketplaces. While the amount charged to each ATS and Participant is based on that entity's share of total trading volumes (i.e., the number of securities traded), trading volume on all marketplaces is aggregated. This means that RS collects the same amount for each trade of the same size regardless of the marketplace on which it takes place.

To calculate the monthly UMIR regulation fee charged to each ATS and Participant, RS takes its costs for that month and charges each ATS and Participant its pro rata share of that amount based on the portion of total trading volumes for the month that took place on that ATS or that was conducted by that Participant. RS also charges an annual fee of \$5,000 to each Participant and ATS.

The UMIR regulation fee is presently subject to a volume cap on each trade of 30,000 shares (the "Volume Cap"). In addition, since October 2004, 70% of the volume of trades pursuant to market maker obligations has been excluded from a Participant's volume and the overall adjusted volume of RS-regulated marketplaces for the purposes of calculating the UMIR regulation fee (the "Market Maker Exemption"). The volume on the other side of any trade involving a market maker is included in the calculation of overall volume.

Issues with the Current UMIR Regulation Fee Model

Recent developments in trading and the emergence of new marketplaces have required RS to re-assess its UMIR regulation fee model.

The recent growth of algorithmic trading has dramatically increased the ratio of orders to trades. While there has been a steady increase in the overall value, volume and number of trades on regulated marketplaces (with increases of 28% for total trade value, 21% for total trade volume, and 44% for total number of trades over the four-year period of RS's operation), the number of orders entered on marketplaces has increased more than fivefold over the same period with growth of more than 171%. RS expects these trends to continue.

Presently, only the TSX and the TSXV are integrated into RS's automated surveillance systems that generate "alerts" when abnormal trading patterns are detected. RS monitors trading on CNQ and the ATSSs using "stand-alone" surveillance systems. While RS has modified its systems to permit them to receive order and trade data from CNQ and the ATSSs, that data cannot yet be analyzed by RS's automated alerts and other surveillance tools, meaning that RS surveillance personnel must monitor orders and trades on those marketplaces manually, at higher cost.

In addition, notwithstanding the increasing divergence of trading patterns on the marketplaces for which RS is the regulation services provider (for example, marketplaces with large minimum trade sizes vs. marketplaces that attract a large number of orders and small trades), RS's current UMIR regulation fee does not vary among marketplaces – an ATS or Participant's UMIR regulation fee is based on its share of trading volume across all marketplaces.

As a result, the current UMIR regulation fee model creates a risk that UMIR regulation fees calculated on this basis may be creating subsidies across marketplaces, where trading on marketplaces that are relatively more expensive to monitor is subject to the same volume-based UMIR regulation fee as trading on marketplaces that are relatively less expensive to monitor.

RS Review of Fee Model

Beginning in April of 2006, RS undertook a detailed review of RS's fee model, as it relates to UMIR regulation fees and to one-time capital expenditures like those required in connection with the introduction of new marketplaces.

RS staff performed a detailed analysis of RS's existing cost structure and fee model, to develop recommendations for a new fee model that would best allow RS to charge fees on a cost recovery basis in accordance with its recognition order and other requirements set out in RS's regulation services agreements.

RS determined that an "activity-based" model would more accurately reflect the actual "drivers" of RS's costs. A better understanding of the factors that actually determine RS's costs would, in turn, enable RS to develop a fee model that better represents equitable cost recovery as between marketplaces.

In developing the Proposed Fee Model, RS had regard to certain "guiding principles" relating to RS's fee model, as set out in RS's recognition order and regulation services agreements. Those guiding principles require RS to:

- have a fair, transparent and appropriate process for setting fees;
- charge fees on a cost-recovery basis;
- allocate fees on an equitable basis among marketplaces and marketplace participants;

- balance the need for RS to satisfy its responsibilities without creating barriers to access; and
- reflect that all marketplaces and other persons concerning whom RS provides regulation services should pay a fair share of all RS's costs, including fixed costs, of providing such services.

Details of and Rationale for the Proposed Fee Model

Based on a detailed analysis of RS's costs, including personnel costs, information technology ("IT") costs, and overhead costs, RS identified functional areas as discrete cost centres. (All areas, other than the three Market Policy counsel, are further tracked separately in RS's Toronto and Vancouver offices.) For each of these functional areas, RS identified cost drivers, based on its analysis of the regulatory activities performed by personnel in each area.

The table below sets out the functional areas and cost drivers for each area.

Functional Area	Cost Driver ²
Surveillance	<ul style="list-style-type: none"> • personnel: <ul style="list-style-type: none"> ○ marketplaces for which RS performs automated monitoring (currently TSX and TSXV): number of alerts ○ marketplaces for which RS performs manual monitoring: number of orders and trades • IT: number of orders and trades (all marketplaces)
Trade Desk Review	<ul style="list-style-type: none"> • number of completed files
Trading Review & Analysis	<ul style="list-style-type: none"> • number of completed files
Investigations	<ul style="list-style-type: none"> • number of completed files
Enforcement	<ul style="list-style-type: none"> • number of completed files
Market Policy Counsel	<ul style="list-style-type: none"> • time spent on marketplace-specific matters

A brief overview of the rationale for selecting these cost drivers is as follows:

- surveillance personnel costs for marketplaces for which RS performs automated monitoring: surveillance personnel activity is focussed on responding to alerts generated by RS's automated monitoring systems;
- surveillance personnel costs for marketplaces for which RS performs manual monitoring: surveillance personnel must review the orders placed and the trades that take place on the marketplace, without the benefit of automated alerts to identify potential violations associated with specific orders and/or trades;³
- surveillance IT costs: RS has determined that its IT costs for surveillance are primarily driven by the processing and storage capacity required to monitor orders and trades for all marketplaces (whether or not RS performs automated monitoring);

² IT and personnel costs are treated separately only for surveillance; for all other areas, IT costs are included in overall costs and allocated using the same cost drivers.

³ Only trades are counted for marketplaces that do not provide pre-trade order visibility.

- trade desk review, trading review & analysis, investigations and enforcement: the activities of personnel in these areas culminate in completed files;
- Market Policy counsel: the three Market Policy counsel keep records of their time spent on marketplace-specific matters (exemption requests, interpretations, etc.), and allocate the remainder of their time to general overhead.

The process to determine the UMIR regulation fee based on this approach is as follows:

1. For each functional area, RS determines what portion of RS's total costs (including IT costs) are attributable to the area, based on its internal management accounting processes.
2. RS then calculates a unit cost associated with the cost driver for that area by taking the total cost allocated to that area and dividing that amount by the output of that area, as measured by the cost drivers identified above.
3. RS then multiplies the unit cost by the units of output attributable to each marketplace based on time spent, to arrive at that marketplace's monthly fee for that functional area.

For example, the total cost allocated to investigations for a month is divided by the number of investigation files completed in that month. This produces a unit cost for each completed investigation file. Each marketplace is then charged an amount in respect of investigations that is the product of the number of investigation files relating to that marketplace multiplied by the unit cost per investigation.

The following is a hypothetical calculation (for illustration purposes only):

A – Monthly Cost for Investigations	\$100
B – Number of Files Completed in Month for All Marketplaces	5
C – Unit Cost per File Completed (A/B)	\$20
D – Number of Files Completed for Marketplace “X”	3
E – Amount Charged to Marketplace “X” for Investigations (CxD)	\$60
F – Number of Files Completed for Marketplace “Y”	2
G – Amount Charged to Marketplace “Y” for Investigations (CxF)	\$40

Where an activity relates to more than one marketplace (e.g., a trade desk review is completed for a Participant that is a member of more than one Exchange, or an investigation relates to trading on more than one marketplace), the unit cost of that activity is allocated to the marketplaces based on time tracking by RS personnel.

The remaining costs associated with overhead areas (management, human resources, finance and market policy (other than the three Market Policy counsel)) are allocated to each functional area based on the relative direct costs of those functional areas.

RS will discontinue the \$5,000 annual fee charged to each Participant and ATS, as the Proposed Fee Model fully recovers RS's costs from all functional areas.

The Proposed Fee Model does not incorporate either the Volume Cap or the Market Maker Exemption. These adjustments are not required because UMIR regulation fees will not be calculated on the basis of trading volume.

In addition, RS will calculate the UMIR regulation fee at the marketplace level, based on activity attributed to each marketplace as described above. Each marketplace will then determine how to recover the UMIR regulation fee from its members or subscribers, as the case may be.⁴

Impact on Marketplaces of Proposed Fee Model

RS has tested the Proposed Fee Model against actual activity levels for the months of August, September and October, 2006. This testing indicates that UMIR regulation fees in respect of trading on the TSX will decrease, while UMIR regulation fees in respect of trading on TSXV, CNQ and the ATs will increase individually, and in the aggregate by a corresponding amount.

This is a result of the fact that the current fee model is based solely on trading volume, even though a portion of RS's costs to provide UMIR regulation services is fixed and therefore independent of trading volumes (i.e., this cost would be incurred in respect of a marketplace even if there was no trading on that marketplace in the period). The Proposed Fee Model more accurately captures these fixed costs of providing UMIR regulation services, while also providing a mechanism to measure variable costs.

In addition, the current fee model does not assign the costs of trading review & analysis, investigations or enforcement to specific marketplaces. These costs can, however, be readily allocated to specific marketplaces (through time tracking), and in some months may be significant. Allocating these costs directly to the marketplace will eliminate a subsidy that otherwise might exist for marketplaces that have small trading volumes but that nevertheless give rise to material – and costly – trading review & analysis, investigation and enforcement activity.

Based on activity levels for September 2006, ATs that would have paid approximately \$500 for that month under the current UMIR fee model (comprising the monthly portion of the \$5,000 annual fee plus the ATs's pro rata share of RS's costs based on trading volume) would pay between \$2,000 and \$3,500 for that month under the Proposed Fee Model.

The impact of the Proposed Fee Model on individual Participants and subscribers to ATs will depend on the model that each marketplace adopts to allocate UMIR regulation fees among its users. RS therefore cannot quantify the precise impact of the Proposed Fee Model for each Participant and ATs subscriber. However, to the extent that a Participant conducts the majority of its trading on the TSX, and the TSX chooses to allocate the UMIR regulation fee among its participating organizations based on their share of trading volume, that Participant will likely pay less in UMIR regulation fees. To the extent that a Participant conducts the majority of its trading on TSXV and/or CNQ, and those marketplaces choose to allocate the UMIR regulation fee among their members based on their share of trading volume, that Participant will likely pay more in UMIR regulation fees.

RS will incur additional overhead costs associated with administering the Proposed Fee Model, but these additional costs are not expected to be material. Any incremental costs that RS incurs to bill Participants directly at the request of a marketplace (as opposed to billing the marketplace itself) will be billed back to that marketplace.

Further Proposals re Costs

On November 17, 2006, RS published *RS Notice 2006-007 - Request for Comments – Proposed Allocation of Costs – First Group*, describing the proposed allocation model for a series of direct charges to marketplaces to recover operational and capital costs caused by the introduction of new marketplaces. RS Notice 2006-007 relates to the first group of a number of pending charges and proposals relating to RS costs and fees.

As noted in RS Notice 2006-007, RS is developing a further proposal in relation to the costs to consolidate marketplace regulatory data and to develop displays and tools to provide effective cross-market monitoring. This further proposal is still subject to RS Board review and approval, and so will be published separately.

The Proposed Fee Model is separate from each of these proposals.

RS believes that the Proposed Fee Model is consistent with the goal of a fair and transparent fee structure for the self-regulatory organization to be formed by the proposed merger of RS and the IDA, and intends to carry this model forward into the new organization.

Status and Timetable

If the Recognizing Regulators approve the Proposed Fee Model, RS will implement the Proposed Fee Model as soon as possible following approval.

⁴ RS may, at the request of a marketplace, enter into a billing arrangement with the marketplace to collect UMIR regulation fees directly from Participants that are members or subscribers of the marketplace, for an additional charge (to recover RS's administrative costs) and on other terms to be agreed between RS and the marketplace.

Questions / Further Information

For further information or questions concerning this notice contact:

Doug Harris
Director of Policy, Research and Strategy
Market Policy and General Counsel's Office
Market Regulation Services Inc.
Suite 900
145 King Street West
Toronto, Ontario M5H 1J8

Telephone: 416.646.7275
Fax: 416.646.7265
e-mail: doug.harris@rs.ca

ROSEMARY CHAN
VICE PRESIDENT, MARKET POLICY AND GENERAL COUNSEL