

VIA FAX AND E-MAIL

October 19, 2000

British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Securities Commission
The Manitoba Securities Commission
Ontario Securities Commission
Office of the Administrator, New Brunswick
Registrar of Securities, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland
Registrar of Securities, Northwest Territories
Registrar of Securities, Yukon Territory
Registrar of Securities, Nunavut

c/o John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
Suite 800, Box 55
Toronto, Ontario M5H 3S8

- and -

Commission des valeurs mobilières du Québec
800 Victoria Square, Stock Exchange Tower
Box 246, 22nd Floor
Montréal, Québec H4Z 1G3

Attention: Claude St. Pierre, Secretary

RE: PROPOSAL TO REGULATE ALTERNATIVE TRADING SYSTEMS

The Toronto Stock Exchange appreciates this opportunity to respond to the Canadian Securities Administrators' re-proposed rules governing the operation of Alternative Trading Systems in Canada (the "Proposal").

Our detailed comments follow. Although the TSE still has concerns about certain aspects of the Proposal, particularly with respect to the Request for Proposal for a data consolidator and the market regulation

model, we believe the Proposal generally provides an effective regime to govern the entry and operation of ATs in Canada. We are pleased that the CSA has taken to heart many of the comments we made in response to the previous proposal (the "1999 Proposal"). The TSE hopes that the comments in this letter will assist the CSA in developing the final rules.

OVERVIEW

The CSA's Objectives

Reiterating a point from our previous letter, the TSE strongly supports the CSA's goals in setting up a regulatory regime for ATs. Like the CSA, the TSE believes that ATs should be permitted to operate in Canada, subject to a regulatory regime ensuring that high standards of market integrity and investor protection remain basic principles. The TSE also agrees that both market information and trading must be consolidated across all trading systems so that investors will be able to see the best price for a security and obtain that price.

The Need for Flexibility

The TSE believes that, more than ever before, the overall regulatory regime needs to be flexible and responsive to new developments. As evidence, one need only consider the dramatic events that have occurred in the environment since the 1999 Proposal was issued, such as realignment of the Canadian exchanges, the OM bid for the LSE and the proposed GEM alliance.

Many of these events could not have been anticipated at the time the 1999 Proposal was issued. It is reasonable to conclude that the pace of change will accelerate, putting increased pressure on local markets and local market regulators to respond to new global competition in a timely and effective manner.

This means that the rules governing the marketplace, including the "framework rules", should be capable of being changed quickly and administered flexibly, in response to the changing environment. The TSE believes this imperative reinforces the need to employ the SROs and the principles of self-regulation as the primary drivers of market regulation.

Market Regulation

The TSE endorses the CSA's statement in support of an "industry solution" to the need for comprehensive market regulation at the self-regulatory level. We believe it is imperative that all market centres be covered by the SRO system, in order to (1) ensure uniform high standards of conduct and market integrity across all markets in Canada; (2) provide a fair basis for competition without providing incentives to compete based on lower standards of market regulation.

In order to ensure a well-regulated, responsive market structure we believe the CSA should rely to a greater degree on the extensive self-regulatory infrastructure, systems and operating processes already in place. The TSE believes that the approach to delivering market regulation that the TSE and the IDA are proposing will ensure investor protection and vigorous competition for trading services, as well as promote an efficient, responsive equities market in Canada.

Data Consolidation

The TSE believes that fundamental issues remain with the approach to the market data consolidator. Based on the RFP, the CSA proposes to mandate the creation of a new layer of technical and business processes between the marketplaces and the information vendors. The TSE questions the advisability of the approach: the resulting system will impose additional expense on market participants, will require a great deal of time to implement because of operational impact on the marketplaces, information vendors and users, and will not produce an information set that will fully satisfy the needs of market participants.

The TSE and others believe that the basic objectives of data consolidation can be achieved by using a phased approach employing existing infrastructure, at a much lower cost, provided that the CSA is flexible on the manner in which the data consolidator is organized and distributes consolidated data.

The TSE recommends that the CSA take the same approach to market data consolidation as it has taken for trade integration: to mandate the objectives, but to leave it to the markets and the industry to determine how best to implement them. Based on discussions with OSC staff, we understand that the CSA intends to be flexible in this regard, and we applaud this approach.

Finally, we note that Nasdaq Canada must be subject to the same rules and principles of consolidation as other marketplaces. If not, any action by the CSA will necessarily be incomplete, as it will not encompass the entire Canadian equities market.

MARKET REGULATION AND ATSS

The request for comment does not take a position on the appropriate body to perform market regulation of ATSS but solicits input from the industry. The request notes a concern about conflicts of interest that may arise if an ATSS is regulated by an exchange which it competes with for order flow. On the other hand, the request notes that exchanges view market regulation as essential to ensure market integrity and the exchanges' reputations and "brand names".

Need to Address Market Regulation

To reiterate the point made in our previous letter, the central objectives of the regulatory regime should be to foster liquid, efficient and competitive Canadian capital markets, market integrity and investor protection. The regime must also strike an appropriate balance in a competitive environment by establishing a level playing field for all providers of trading services, be they exchanges or ATSS.

If an ATSS is not required to join an SRO that performs market regulation, it will be subject only to the CSA's framework trading rules. This gap creates incentives for standards to be reduced by making it possible for market participants to choose to trade in an ATSS to avoid the application of stock exchanges' rules. The framework rules may become the only market standards. Again, this framework is incomplete and inadequate in comparison to the exchanges' existing rules.

The TSE has consistently pointed out that it will be difficult for an exchange to compete on the basis that it offers higher regulatory standards if those standards prevent a market participant from doing a trade that could otherwise be done in an ATSS. The ATSS can compete for that order flow on the basis of the minimum standards established by the CSA. And competition will exist on a trade-by-trade basis, with each trade being made based on price, liquidity, cost and ability to do the trade under the applicable rules.

This is the fundamental reason why the TSE has consistently opposed the Rule ATS category of registration. In the absence of an SRO that governs all marketplaces, the regulatory gap will create a regulatory race to the bottom, forcing the exchanges to lower their standards to preserve order flow. We assume these are not the kind of incentives the CSA wishes to introduce, since the commissions and the SROs have been cooperating to raise the standards of conduct in the securities industry, not lower them.

U.S. Regulation of ATSs

We observe that, throughout the development of the ATS Proposals, the approach to market regulation and the role of SROs has been informed by a view of the U.S. regulatory regime which we do not feel is completely accurate. The Proposal is predicated on the view that ATSs have a choice of SROs in the U.S., that one of them is the NASD, which has separated NASD Regulation from Nasdaq, and that therefore potential conflicts of interest arising from an ATS being regulated by their competitors has been addressed. This is not an accurate picture of the U.S. regulatory regime. The essential elements of this regime are:

1. All broker-dealers, including ATSs/ECNs, must be NASD members.
2. All broker-dealers trading Nasdaq issues are Nasdaq participants and are subject to the Nasdaq rules.
3. Nasdaq and NASDR both have Rulebooks. Nasdaq rules cover the operation of the Nasdaq Stock Market, including trading rules and facilities.
4. Nasdaq contracts with NASDR to carry out many of its regulatory functions.
5. Because of demutualization, Nasdaq is in the process of registering as a stock exchange with the SEC. As such, the SEC will hold Nasdaq responsible for its SRO functions. Nasdaq retains accountability and control through its services contract with NASDR.
6. Since ATSs/ECNs are subject to all Nasdaq rules, they are being regulated by their competitor. ECNs have explicitly complained about the fact they are being regulated by their competitor, in the

current debate over Nasdaq's proposed Supermontage trading system.

7. In addition to NASDR/Nasdaq rules, ATs/ECNs are also subject to the specific requirements of the SEC's Rule ATS.
8. ATs/ECNs may choose to register as an exchange with the SEC if they do not want to operate as a registered dealer.

To summarize, in the U.S. ECNs do not have a choice of regulator, and are being regulated by Nasdaq, which they consider a competitor.

In Canada, the TSE took steps to address the conflict of interest issues when it introduced its demutualization proposal, by announcing the creation of TSE Regulation Services, an autonomous arm of the TSE to house all of its regulatory functions, which would continue to operate on a non-profit basis.

The situation is also quite different in Canada because, unlike NASD, the TSE does not carry out member regulation and therefore is not involved in regulating firms' business operations, customer relationships or capital positions. The TSE focuses on the core function of regulating equity markets, a fairly narrow area of operation. Notwithstanding that, the TSE has taken significant steps to address conflict of interest issues, and, with our proposal to house Regulation Services in a separate company, is proposing to take additional steps in order to provide the most efficient and effective solution to the delivery of market regulation functions.

In conclusion, the TSE's proposed solution is akin to Nasdaq's except that the scope of the potential conflicts is much narrower in the TSE's case.

Therefore, to address this regulatory gap, the TSE submits that ATs must be required to join an SRO that will have full powers to regulate all marketplaces and market participants or register as an exchange with self-regulatory responsibilities. The TSE will bring forward an industry solution that promotes market integrity while allowing for vigorous competition among trading service providers.

A Market Regulation Solution

Over the past several weeks, TSE management has met with the IDA Equity Trading Committee, and discussed the issue with the other Canadian exchanges. The TSE and IDA Committee have agreed in principle on a model that would establish TSE Regulation Services as an affiliate corporation of TSE Inc., with participation by the IDA. The details of the model are under discussion. Our objective is to propose a market regulation model, supported by an industry consensus, that can be implemented at the same time as the ATS rules. We expect to be in a position to discuss the proposal with the CSA in the near future. The basic principles of the proposal are set out in appendix A.

The intent is not to have TSE Regulation Services Inc. regulate the business operations of marketplaces, but to set standards of market integrity. Of course, there is no bright line, as rules designed to ensure fair markets and investor protection (such as anti-manipulation rules or restrictions on short sales) will necessarily impact the mechanics of trading to some extent. However, such rules would apply to all marketplaces, including the TSE.

Furthermore, if Regulation Services Inc. is created, the TSE suggests that the Proposal should be simplified. For example, the CSA would not need to establish many of the framework trading rules at the Commission level. Instead, Regulation Services Inc. can adopt rules that address the substance of the framework rules, at a self-regulatory level. This would enable the full Rulebook and its administration to be delivered at the SRO level. We undertake to harmonize these rules with other SROs, such as CDNX, and have initiated a rule review project to this end. (Note that the proposed Regulation Services model is designed to accommodate the participation of other exchanges, as well. Initially it is designed to oversee trading in TSE securities, but is flexible in this regard.)

The CSA's framework rules should then be limited to those needed to cover activities by persons outside SRO jurisdiction, such as the proposed anti-manipulation rule, which should apply to all market participants, not just SRO members. This is discussed in more detail under the heading "Trading Rules" below.

Similarly, since ATs would be members of the SRO, they would not have to contract with an approved agent for market surveillance, although that option should be available to ATs that choose to register as an exchange.

This approach is consistent with the IOSCO *Objectives and Principles of Regulation*, which state that a securities regulatory regime should make appropriate use of SROs for their respective areas of competence. It is also consistent with the recent Commission initiatives to require securities dealers and mutual fund dealers to become members of an SRO.

If the CSA permits ATs to operate outside of the self-regulatory system, it will have to take a much greater role in front-line market regulation. In particular, the CSA will need to respond in a timely fashion to address 1) the gaps that will inevitably appear in the framework trading rules; 2) the exchanges' need to remove many of their rules and requirements in order to be competitive; and 3) new trading practices that may give rise to market integrity or investor protection concerns. This is discussed more fully under "Trading Rules" below.

DATA CONSOLIDATION

Although a number of the TSE's suggestions have been incorporated into the Request for Proposal for the market data consolidator, the TSE continues to have concerns about the proposed model and recommends that the CSA take a more flexible approach. The Canadian Exchange Group (CEG) believes that an alternative approach can respond to the Commissions' concerns with a more cost-effective model that can be implemented in a shorter time frame.

The TSE is of the view that the CSA should not mandate the creation of a new layer of infrastructure between the marketplaces and the information vendors. Instead, as detailed in the CEG response to the RFP, existing systems should be leveraged to support the operations of the data consolidator (DCS).

The existing system for disseminating consolidated market data through the Canadian Exchange Group has worked well for almost 15 years. The CEG evolved to position the exchanges to serve the needs of users of Canadian market data worldwide. CEG provides a single point of connectivity for access to Canadian trade and price information for listed equities and derivatives. In developing the model for data consolidation, the CSA does not appear to be giving sufficient recognition to the successful working relationships that the CEG

exchanges have developed over years of effort with the vendor and user communities.

The Proposal and accompanying RFP also contemplate a high degree of CSA involvement in both the design and operation of market data infrastructure. In this respect, it is a marked departure from the approach taken in the rest of the Proposal, and indeed from the model for consolidation of market information for the debt market.

The TSE believes that leveraging the CEG's existing technical, business and administrative infrastructure will result in a market data consolidation solution that is superior to the model contemplated by the CSA, in terms of its time to market, cost to users and implementation impact on the marketplaces and data customers. The CEG proposal envisages two phases. In phase one, completion in September, 2001, marketplace feeds providing one line quotes (open, high, low, close, net change, last sale, best bid/offer) and visible limit order details for all listed issues will be consolidated and managed through a central facility. In phase two, targetted for April, 2002, additional value added features will be provided, as specified by market participants working through the Advisory Committee proposed by the CSA.

Under this approach, the information vendors would have centrally managed access to the building blocks necessary to create a variety of consolidated information displays (market by order, market by broker, market by price, for example) required by their customers. The availability of individual limit order details would also support the marketplaces to provide best market execution facilities.

Utilizing this model will not require that the CEG (as DCS operator) be mandated as the exclusive agent for the dissemination and sale of real-time Canadian market information, which will avoid the difficult issues associated with market data ownership. The TSE believes that the technology and the governance model proposed for CEG operation of the DCS will be sufficiently transparent to address any potential conflicts of interest that might arise. The proposed terms and conditions of the agreement to operate the DCS would empower the CSA to periodically review the CEG's performance of its DCS operations. The agreement would also set out the process for possible replacement of the CEG as DCS operator. Keeping in mind the reality that the replacement of any DCS operator will only occur after months of review, the TSE believes that suitable arrangements can be made to

avoid the interruption of the delivery of consolidated Canadian market information, if necessary.

The TSE supports the view that marketplaces, both traditional and new entrants, should be free to experiment with new methodologies to broadcast their real-time market information. In the event that the CSA requires the implementation of a separate infrastructure, requiring a significantly greater up-front investment, and higher annual operating costs, it may be necessary to mandate exclusive use of the DCS to ensure that this large initial investment is recoverable. Another likely result is that the market data customer base would have to absorb the additional costs through materially higher user fees. The TSE does not believe that the implementation of a separate infrastructure is necessary to achieve the CSA's goals for the DCS.

Rather than set out in detail the requirements for market data consolidation, we believe that the best approach is the one that the CSA is using for trade integration: mandate the objective (full availability of market data) and leave it to the markets and the industry to determine how best to achieve them.

TRADE INTEGRATION

The TSE agrees that ATs should be required to link with the primary market for a security and that trade throughs of better prices should be prohibited. The flexible approach set out in the Proposal will allow the markets to develop a cost-effective solution that can be implemented in a timely manner.

The TSE has extensively analyzed the requirements for integration of trading between the TSE and ATs trading TSE-listed stocks. There are three potential solutions for integrating trading in order to transmit marketable orders to the market centre with the best available price: 1) a central integrator which routes all orders across all marketplaces; 2) a distributed model which allows for multiple providers of best market order routing capability; 3) a market centre approach, with each marketplace being capable of rerouting orders to another marketplace. Each alternative has advantages and disadvantages.

A central solution would provide all participants with the same routing facilities. A central model will involve some network transmission delays that will impact the handling of orders. The CSA and the industry would need to address a business model to support a central

integrator and enable its costs to be covered, which could be considerable.

Desktop solutions for trading firms which provide access to multiple sources of liquidity and route orders based on best available price and client preference are easier and cheaper to deliver today due to recent advances in technology. Increasingly, firms are looking for a single desktop access mechanism to all sources of liquidity, not just those in Canada. Some vendors are already providing some of this functionality, and others have indicated their intention to do so.

Under the third alternative, each market centre would develop the capability to reroute orders to other market centres.

We propose a meeting with CSA staff in the near future in order to discuss the approach to trade integration, and how the TSE could provide a practical solution to the CSA's requirements for orders transmitted to the TSE.

TRADING RULES

The TSE generally supports the amendments made to the framework trading rules although, as noted earlier, many of them do not need to be adopted by the CSA if a SRO has authority to regulate trading in all marketplaces.

Relying on self regulation will ensure that the markets remain responsive to new competitive pressures that arise domestically and internationally. This objective is unlikely to be achieved if the CSA takes on a greater role in "front-line" market regulation. CSA Rules can only be changed through co-ordinated action by the CSA, which can be very time consuming. The Proposal itself is evidence of that.

Responsiveness is also an issue at the level of daily market oversight. For instance, exemptions from trading rules could only be obtained from the CSA through application procedures that are simply not designed to provide a timely response to a trading issue or problem, no matter how willing commission staff may be to accommodate a request. As we stated in our previous letter, the nature of trading demands a quick response to many issues that arise.

Under the SRO-based approach, we still recommend that certain framework rules be adopted, since SROs do not have regulatory jurisdiction over all market participants. The TSE continues to strongly support the proposed anti-manipulation rule. We also agree that the framework rules should cover certain areas such as, best execution, subject to the comments noted below.

In order to promote the most flexible and responsive regulatory regime (assuming the CSA determines that the complete framework rules are necessary) the TSE strongly urges the CSA to fully delegate the monitoring of, administration (including the ability to grant exemptions) and enforcement of these rules to Regulation Services and other SROs as required.

Short Sale Rule

As noted in our last comment letter, the TSE's short sale rule contains a number of exemptions that are not in the proposed framework rule. These exemptions help foster more liquid and efficient markets by permitting certain trades where concerns about potential market manipulation are minimal or non-existent. Some, such as exemptions allowing Registered Traders to sell short in fulfilment of their market making obligations, are necessary to ensure continuous two-sided markets. This framework rule should be delegated to SROs, or at a minimum a blanket exemption needs to be provided for trades done on a recognized exchange in accordance with its rules.

Order Handling Rule

The proposed order exposure rule contains no exceptions. For many securities, display of orders smaller than \$100,000 in value will have an adverse market impact. The requirement to immediately transmit all orders of that size in full to a marketplace, regardless of the nature of the security or the circumstances, will jeopardize the best execution of clients' orders. Traders will not have the option of entering the order in smaller portions in a visible market in a bona fide attempt to get a better fill for the client. Nor will the client be able to request that their order be withheld.

The TSE supports the adoption of a general order handling rule, but submits that the implementation of the rule should be delegated to the SROs, which will provide for exceptions similar to those contained in TSE Rule 4-402.

Audit Trail Requirements

The TSE agrees that complete audit trails are vital for effective market regulation, especially with respect to the best execution of orders. The TSE has recognized the need for improved audit trails, including better tracking of orders before they are entered on the TSE or another market. We initiated a project in the second half of 1999 to develop the requirements for an electronic audit trail system for the TSE. CDNX has agreed to participate in the project, with a view to developing a national standard. Market Surveillance staff involved in the project met with OSC staff in August of 2000 to discuss the general goals, findings and progress of the project. It was agreed at that time that TSE and OSC staff would co-operate in the development of a suitable audit trail system.

The Proposal's approach appears to be based on the NASD's OATS system, which was designed for Nasdaq's dealer market structure. The Canadian markets are full auction markets where firms submit all orders to a central limit order book and where a record of all orders, quotes, and trades are stored. Nasdaq does not expose or centrally record orders and trades are reported after execution. The TSE believes that a better, more efficient and less costly solution than OATS should be created for the Canadian market.

We therefore recommend that the CSA not adopt the proposed framework rule but rather wait for the outcome of the SROs' initiative. We will be actively working with our Participating Organizations to develop an effective system. Any concerns the CSA has about the comprehensiveness of the SROs' proposal may be addressed through consultation and the rule approval process. The TSE's intention is to release the proposed requirements for an electronic audit trail system this fall, and the implementation plan early in 2001.

MISCELLANEOUS COMMENTS

Payment for Order Flow

The TSE is concerned that ATs may pay for order flow as many have in the United States. This will force the exchanges to do the same to compete, even if they do not believe that the practice is in the best interests of investors. This scenario is currently observed in the American options market, where all options exchanges are compelled

to pay for order flow in order to compete, contrary to their own view of the best interests of investors.

We believe that payment for order flow creates a clear conflict of interest for firms routing client orders, because the order could be routed based on financial benefits to the brokerage firm rather than obtaining best execution of client orders.

For this reason, we recommend that the CSA prohibit payment for order flow. We understand from discussions with OSC staff that an ATS that pays for order flow would be considered to be offering a liquidity guarantee, requiring it to register as an exchange and be subject to a greater degree of CSA oversight. This is not our recommended approach because it does not address the fundamental conflict of interest issue. What does the CSA plan to do if an ATS or exchange in fact pays for order flow? Will CSA approval be required? We believe these questions must be answered now, because anecdotal evidence is that payment for order flow is being planned, and given it is a widespread (and controversial) practice in the U.S.

If the CSA does not ban the practice, we submit, at a minimum, that the requirement to register as an exchange should be explicit in the regulations, along with rules that address conflict of interest.

ATS Securities

The TSE recommends that ATSS should not be permitted to trade securities of issuers which are not listed on an exchange (Canadian or foreign) recognized as having acceptable listing requirements and sound regulatory oversight of it listed issuers. In addition, all issuers whose securities are traded should be reporting issuers.

This requirement would prevent ATSS from becoming a new home for trading in unlisted penny stocks, which have frequently been promoted and sold without regard to investors' best interests, both in Canada and other jurisdictions. It is contrary to the principles of investor protection and market integrity to permit ATSS to become a vehicle for such practices.

Trade Report Transmittal

We do not agree with proposed section 11.5 of National Instrument 21-101 that allows an ATS to submit order and trade information to its

surveillance agent with a delay of up to 90 seconds. Access to real-time information is crucial to effective surveillance. We understand the intent was not to allow an ATS to hold back orders but to address concerns that a requirement to report "immediately" may be impractical if there is some latency in the data feed. While we agree that there may be latency in some cases, it should be minimal. The rule should be amended to state that the ATS must provide its surveillance agent with real time order and trade data feeds.

The TSE would be pleased to respond to any questions or comments on the views set out above. If you have any questions or wish to discuss this letter further, please contact John Carson at 416/947-4572 (jcarson@tse.com) or Timothy Baikie at 416/947-4570 (tbaikie@tse.com).

Yours truly,

Barbara Stymiest

Appendix A

TSE REGULATION SERVICES INC. MARKET REGULATION MODEL

The TSE proposes to form a separate not-for-profit affiliate corporation to provide market regulation services under the following structure:

Ownership

- Initially, the corporation would be owned 60% by Toronto Stock Exchange Inc., and 40% by the Investment Dealers Association.
- Other exchanges and alternative trading systems will be encouraged to participate in the corporation, and the ownership interest of both the TSE and IDA would be reduced on the addition of new participants.
- The TSE would only relinquish a control position if the TSE ceases to be the primary Canadian equity market
- The interest of any new participant in the corporation would be determined at the time of admission.

Governance

- Initially, the Board of Directors of the corporation would be comprised of 11 directors:
 - The TSE would appoint 6 nominees (3 representatives of Participating Organizations and 3 independent public representatives);
 - The IDA would appoint 4 nominees (2 representatives of member dealers and 2 independent public representatives); and
 - the President of the corporation.
- The representation of new participants would be determined at the time of admission.
- Both the IDA and the TSE would nominate persons to represent alternative trading systems in accordance with their presence in the market, and institutional investors.

Mandate

- The corporation should be recognized as a Self-Regulatory Organization with a mandate from the Canadian Securities Administrators to develop, administer and enforce market integrity rules as a central market regulator in a cost-effective manner by providing rule development and interpretation, surveillance, investigation and enforcement.
- The corporation would also administer any marketplace specific rules and policies adopted by exchanges or other markets, and could provide additional regulatory services to any exchange with respect to listed companies, the market making function, etc.