May 30, 2011

Secretary of the Commission,
Ontario Securities Commission,
20 Queen Street West,
Toronto, Ontario, M5H 3S8
jstevenson@osc.gov.on.ca.

Dear Sir,

Application for Recognition of Alpha Trading Systems Limited Partnership and Alpha Exchange Inc. as an Exchange – Notice and Request for Comment

I write to share with the Commission my 25 plus years of experience in exchange regulation. I must however inform the Commission at the outset that I am currently engaged as a consultant by CNSX Markets Inc., which operates a recognised stock exchange that competes with Alpha Trading today and will compete with Alpha Exchange (if and when it is recognised as a stock exchange by the Commission). I have been engaged by CNSX, at least in part, because of my international experience with stock exchanges.

I have been the in-house lawyer at the Stock Exchange of Hong Kong (HKEx) – at a time of tremendous reform and re-organisation. I have advised the Indian Government on the design and creation of the National Stock Exchange of India, which was created as a direct response to the particularly egregious abuses carried out by the broker-owned Bombay Stock Exchange. I have been the CEO of the Bermuda Stock Exchange and helped to de-mutualize the exchange (one of the first exchanges to do so in 1992), and I have advised the World Bank and IMF on capital market development in various countries.

Governance Issues – International Experience

Alpha Exchange's application for recognition as a stock exchange highlights the conflicts of interest that exist between a stock exchange's public interest responsibilities and its business activities. All stock exchanges, including publicly-owned and listed exchanges face conflicts of interest, of course. However, Alpha Exchange's ownership raises particularly difficult issues.

Based on the critical functions they perform, most jurisdictions regard the proper functioning of their stock exchanges as critical to the efficient operation of their capital markets. They therefore see a strong public interest in exchanges operating those markets in a way that promotes market efficiency and commands market confidence. The biggest issue facing regulators today is how to ensure what IOSCO calls "...the maintenance of a proper balance between an exchange's public interest obligations and its commercial interests". History has taught us that the balance is even harder to maintain in the case of broker-owned exchanges.

In the old days most stock exchanges were broker-owned. They were set up by stockbrokers and were exclusively owned by the brokers, for example, the New York Stock Exchange (NYSE), the London Stock Exchange (LSE), and the Toronto Stock Exchange (TSE). This type of exchange operated rather like a "mutual society" or private club and was responsible for the regulation of both the markets it operated and of the members (the brokers) themselves.

The biggest risk of broker-owned exchanges has always been conflicts of interest.

The NYSE was a prime example of the conflicts of interest that exist when an exchange is owned by one group of users (in this case the broker members). The original "Buttonwood Tree" Agreement that formally constituted the NYSE on 17 May 1792 (it was named after a Buttonwood tree at 68 Wall Street under which the brokers used to meet), states as follows:

"We the subscribers, brokers for the purchase and sale of public stock do hereby solemnly promise and pledge ourselves to each other, that we will not buy or sell from this day on for any persons what-so-ever any kind of public stock at less rate than one-quarter percent commission on the specie value of, and that we give preference to each other in our negotiations."

In other words, the brokers sought to exclude other traders and to control the prices at which stocks were bought and sold by fixing the commissions charged by the brokers for trading on behalf of a client. A fixed commission structure effectively prevents the brokers from competing on price and denies the investing public the economic benefits of competitive market forces. In the UK, the stockbrokers' similar practice of imposing minimum fixed-scale fees was cited as an anti-competitive restriction in an anti-trust case brought against the LSE under the Restrictive Trade Practices Act of 1976. It was in part due to the fact that the NYSE acted as a private club that the US Government passed the Securities Exchange Act of 1934, which requires all National Securities Markets to be registered by the SEC. However, it was not until 1975 that the SEC finally forced the broker-owned NYSE to give up its fixed commission structure.

Fixed commissions is just the most egregious of the many forms of restrictive practices that broker-owned exchanges can adopt, in direct contravention of their public interest responsibilities. Other forms of restrictive practice that have been commonly carried on by broker-owned exchanges include:

- a closed system, not allowing new, innovative or remote brokers to have access (e.g., in the old days, preventing remote memberships, ie non-members who are given access to trade on the exchange. In the modern era an equivalent issue would be restricting direct access to the market to new high frequency traders);
- anti-competitive restrictions on the business practices of new traders (e.g., in the old days, restricting the number of offices a member could have and in the modern era an equivalent issue would be imposing restrictions on high frequency trading strategies);
- anti-competitive actions that prevent fair access to competing exchanges (e.g., in the old days, preventing members from joining other markets and in the modern era an equivalent issue would be online brokers providing electronic order-entry to their own exchange but not to other competing markets or charging investors more to access a rival market than they charge for access to their own market);
- Discriminatory pricing practices that favour the owner-members;
- Being slow to innovate with new products that might effect members' existing business practices;
- Introducing order types that benefit their members to the disadvantage of retail investors or other more transparent markets;
- Directing client order flow to their own exchange – even when better execution may be available on a rival market;
- Giving preferential treatment to owner-members in new listing IPO allocations (e.g., the corruption that was exposed within the Listing Committee of the HKEx after the 1987 crash); and
- shutting the exchange down periodically as a tactic to advance the business interests of its owners – like the old Bombay Stock Exchange (frequently) and the HKEx in 1987.

In the last thirty years, the anti-competitive features of broker-owned stock exchanges have become increasingly unacceptable and governments all over the world have sought to make broker-owned stock exchanges more representative of the wider public interest. As with the NYSE, the most common approach has been to require the governing body of the exchange to include a majority of non-broker "independent" representatives. Sometimes, the government insists on appointing a number of government representatives. In the last 15 years, most major exchanges have "de-mutualized" and converted into for-profit companies with broader shareholder bases.

The above is only a brief summary of some of the issues raised by member-owned exchanges in the International context and help to remind us why the OSC must be particularly careful when approving a new Bank-controlled, private club as a new stock exchange in Canada.

The Canadian Context

If Alpha Exchange is approved, the owners will not just be the largest brokers in Canada, they include a group of Schedule I Banks that are widely acknowledged to operate as a classic oligopoly in Canada. In addition, the Banks that own Alpha also own a significant percentage of

CDS, the monopoly clearing system for debt and equities, in Canada. Together, the Bank-owned brokers now control a large percentage of total daily order flow in Canada – since many independent brokers have been swallowed up by them in the last few years. Together, the Bank-owned brokers are responsible for the syndication of many underwritten IPOs. The Banks that own Alpha are also the primary source of early stage loan funding for small and medium size Canadian companies that may someday seek a public listing on an exchange in Canada.

If Alpha Exchange is approved, it will not just be owned and controlled by the largest brokers, it will be owned and controlled by a group that either owns or has a dominant position in the vast majority of Canada's financial services sector.

This fact alone should require the Commission to impose the highest international governance standards on Alpha Exchange, to ensure that it fulfils it public interest obligations and properly manages the inherent conflicts of interest that will exist. In addition though, the history of the business practices of the owners of Alpha Exchange, as demonstrated in their operation of Alpha ATS, emphasises the need for the Commission to put very serious checks and balances in place.

In particular, I suggest that the Commission should bear in mind the following prior or existing business practices of the Alpha ownership group when reviewing Alpha Exchange's application:

- a closed system. Some of the Alpha owners have actively lobbied to restrict direct access to the market for new high frequency traders;
- anti-competitive actions that prevent fair access to competing exchanges. Several of the Bank-owned discount brokerage firms still do not offer their clients electronic order-entry to CNSX, some six years after CNSX was granted stock exchange status;
- Discriminatory pricing practices that favour the owner-members. Lest we forget, when the Banks were the majority owners of the TSE they instituted tiered/bulk discount pricing that disproportionately benefited their brokerages. It is instructive to note that the TSX Group dropped that pricing model after it became a for-profit company with wider ownership;
- Refusing to innovate with new products that effect members' existing business practices. It is interesting to note that Alpha Exchange does not propose to launch a retail debt market in Canada – even though other exchanges around the world are doing so – see for example the LSE initiative here http://www.londonstockexchange.com/about-the-exchange/media-relations/press-releases/2010/londonstockexchangesnewretailbondmarketgoeslive.htm. It is probable that Alpha Exchange is not introducing exchange trading of debt products because it will effect the owners OTC dealing desk business;
- Introducing order types that benefit their members to the disadvantage of retail investors or other markets. IntraSpread is a clear example of an order type that benefits the owners' brokerages while disadvantaging other markets in Canada;

- Directing client order flow to their own exchange – even when better execution may be available on a rival market. The so-called "Momentum" initiative, which rewarded the broker owners with greater equity in Alpha Trading based on the amount of client order flow that they could direct to Alpha ATS, looks like an example of this here in Canada.

Question 1: Is Alpha Group's proposed governance structure, including its proposed role for a ROC, appropriate in the context of Alpha Group's ownership structure and regulatory responsibilities? Does it adequately address the potential conflicts of interest? Alternatively, is requiring 50% independent representation on the Alpha Exchange board of directors appropriate? If so, would a ROC still be appropriate or necessary, and with what level of authority over regulatory matters?

As the Commission indicates, independence on the board is a key component in ensuring that adequate consideration is given to a stock exchange's general public interest mandate. International standards now dictate that more than 50% of the board of a stock exchange should be independent – and I believe that this is even more important in the case of a broker-owned stock exchange. The following quote from a recent World Bank report highlights this:

"Following several decades of evolution, international best practice in developed markets is for independent directors to comprise at least 50% of SRO boards, if not a majority of the directors. This practice applies to both independent SROs and exchanges that remain mutual organizations. It also applies to regulation subsidiaries established by public exchanges. If independent directors make up half or more of the directors, it is more likely that the board will reflect the interests of all stakeholders and that conflicts of interest will be managed well, because members do not control the board."

Self-Regulation in Securities Markets: Working Paper for World Bank Financial Sector Policy Group written by John Carson, August 2010.

The Commission might want to consider the example of the HKEx – where the government reacted to many examples of egregious behavior by broker-owners. Accordingly, there are several features of HKEx's constitutional arrangements which are designed to ensure that the public interest is not subordinated to HKEx's commercial interests, including:

1. half the Board (including the Chairman) is appointed by the Government;
2. HKEx has a statutory duty to give precedence to the public interest over its other interests[1]; and
3. All rule amendments, new products, fees or tariffs of HKEx are subject to vetting and approval by the Securities and Futures Commission (SFC). HKEx cannot act unilaterally in any of these areas. The SFC also has powers to give directions to the exchange and to

[1] Section 21 (2) (b) of the Securities and Futures Ordinance.

approve key appointments. SFC oversight of HKEx includes an annual audit of the way listing regulation is performed.

I do not propose that the independent members of the board of Alpha Exchange must be appointed by the Federal or Provincial Governments in Canada (although the Commission may determine that is appropriate), but I do recommend that Alpha Exchange should have a majority of independent directors and that the Chairman should be independent.

Question 2: Is the definition of independence proposed by Alpha Group to be applied to Alpha Exchange's board directors appropriate in the context and nature of their proposed structure? Are there any other exclusions that would be warranted?

Given the wide scope of the business interests of the owners of Alpha Exchange in Canada, I believe the independence definition for Alpha Exchange should be much wider than for other market places in Canada. I believe that directors, officers or employees of any of the Banks (even if they hold less than 10% of Alpha) should not be seen as independent for this purpose. Similarly, the partners, officers and employees of the main service providers to the banks (e.g., auditors, legal counsel, etc) should be excluded. I recommend that the Commission look at the definition of "Independent" in NI 81-107 (Independent Review Committees for Investment Funds) as a suitably wide definition, since it would exclude people that have a commercial, charitable, banking, legal, accounting or consultancy relationship with any of the owners of Alpha Exchange. In my opinion, the CEO of Alpha Exchange should be an ex officio member of the board but should not be counted as one of the independent directors.

Question 3: Are the proposed terms and conditions of recognition that deal with conflicts of interest and confidentiality appropriate in light of the potential conflicts of interest associated with Alpha Exchange's ownership structure? If not, why not? Would other or additional terms and conditions be more appropriate?

Again, given the wide scope of the Banks' interests in Canada and the extent of the conflicts of interest that will exist, Alpha Exchange should be subject to a duty to give precedence to the public interest over its other interests. This obligation could be imposed in the Recognition Order of the Alpha Exchange and could also be enshrined in the partnership agreement of Alpha Exchange LP. See Schedule 1 for the wording of Section 21 (2) (b) of the Securities and Futures Ordinance, by way of example.

Alpha has stated in writing that it is entering the listings business "..in order to increase competition for listings in Canadian capital markets and thereby decrease associated costs, minimize inefficiencies, provide choice and promote a more vibrant capital market..." I find it odd that the owners of Alpha have not supported CNSX over the last seven years as a way to increase competition for listings in Canadian capital markets and thereby decrease associated costs. This is particularly puzzling given that Alpha Exchange has adopted CNSX's streamlined listing model, with listing policies that are very similar to the CNSX's policies, including an

emphasise on disclosure instead of the exercise of discretion by the exchange in the review of transactions – something which CNSX has pioneered in Canada.

Instead of using CNSX, the owners of Alpha Exchange want to own their own stock exchange, which is of course their right. However, given the prior practices detailed above and the owners' dominant position in the financial markets in Canada, I believe that the Commission should impose an obligation on the owners and members of Alpha Exchange that requires them not to give preference to Alpha Exchange.

For example, in my opinion, it would be entirely inappropriate for brokers that own Alpha Exchange to provide electronic order-entry to their own Alpha Exchange, unless and until they have granted fair access to the rival markets in Canada. Similarly, some of the Bank-owned brokers charge investors higher commission rates to trade on CNSX than TSX or TSXV. It would be entirely inappropriate for those same brokers to provide lower fees for order-entry to their own Alpha Exchange, unless and until they have granted fair price access to the rival markets in Canada.

Accordingly, I recommend that the Commission should impose an obligation on the owners and members of Alpha Exchange that requires them not to give an unfair preference to Alpha Exchange. This must be closely monitored by the Commission and IIROC. So, for example, IIROC would check that those brokerage operations are providing their clients with access to rival markets in Canada that is at least equal to the access provided to their own Alpha Exchange.

Question 5: Should issuers of the same size and quality be subject to an equivalent level of listed issuer regulation by competing exchanges? Are some elements of listed issuer regulation merely "branding" and if so, what are those areas?

The CSA has already established national standards for prospectus disclosure and the continuous disclosure regime – as well as for certain corporate governance requirements. It is entirely appropriate for the CSA to set other national standards that apply to all listed companies, irrespective of which market they choose to list on.

I comment below that the requirements for fund mergers and the approval of foreign jurisdictions for "equivalence" purposes are two areas in which CSA regulations are appropriate.

The area where stock exchanges should be allowed to compete are:

a) Entry requirements. Subject to the CSA's prospectus standards, each market should be allowed to choose which companies it wishes to attract and what the initial entry requirements should be;
b) Listing Fees. Subject to each exchange maintaining adequate regulatory resources to conduct appropriate supervision (which the Commission currently monitors), each exchange should be allowed to set their own initial and ongoing listing fees; and

c) Listing Policies in areas not covered by CSA standards. Exchanges should be able to decide whether to exercise discretion in the review of transactions and whether or not to require additional disclosures or additional shareholder approvals.

Question 8: Should a listed issuer that is an investment fund be subject to the same securityholder approval requirements for acquisitions as mutual funds? In particular, should the investment fund manager bear the costs and expenses associated with an acquisition of a listed issuer that is an investment fund?

As a member of several Independent Review Committees in Canada, I am amazed that closed-end investment funds are treated differently from mutual funds (which are subject to NI 81-102) when it comes to fund mergers. This is an area where the OSC/CSA should set a national standard that applies to all investment funds, irrespective of whether they are mutual funds or listed funds.

The role of the IRC is to review a Manager's proposed actions in respect of conflict of interest matters and determine whether the Manager's proposed action represents a fair and reasonable result for the fund. Where a manager proposes to reorganize two or more funds that are all managed by the same manager, the manager clearly has a conflict of interest. Fund mergers are only proposed in order to meet some business objective of the manager. I do not believe it is appropriate for an IRC to be able to approve the spending of investors' money to pay the costs of a merger that is being proposed by a manager in order to meet the business objectives of the manager. In all such circumstances, the securityholders should be given a vote on whether they want to pay for the merger or not (as they are now under NI 81-102).

Question 9: Should Alpha Exchange's Listing Handbook contain specific criteria relating to listing applications from foreign special purpose issuers, such as investment funds or exchange-traded notes? Should this criteria require Alpha Exchange to consider Staff's assessment that it would be in the public interest to approve such a listing application?

I fully support the concept that companies which are already listed on a well regulated foreign exchange, and thereby subject to a level of regulation that is equivalent to Ontario, should be able to cross-list on a stock exchange in Canada. However, the idea that any exchange in a country where the securities regulator is a member of the IOSCO Technical Committee is suitable is laughably inadequate.

To give just one example, SEBI in India is on the IOSCO Technical Committee. Does that mean that any company listed on any of the 20 or so exchanges in India is suitable for this privileged status in Canada? Of course not. The important question is does a specific exchange (and the securities environment within which its listed issuers operate) provide an equivalent level of investor protection as that imposed in Canada.

This is an area in which the Commission should set the basic standards for all exchanges in Ontario by publishing a list of recognized stock exchanges for this purpose. In my opinion, at a

minimum, the list should include NYSE Euronext, NASDAQ, LSE, ASX, HKEx, Singapore Stock Exchange, and Deutsche Bourse - but exchanges should be reviewed and added on a case-by-case basis after appropriate review of each exchange by the Commission.

I am grateful for this opportunity to share my international experience and to comment on the Alpha Exchange proposal. Please do not hesitate to contact me if I can be of any further assistance.

Yours truly,

W William Woods
President & CEO
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Section 21 (2) (b) of the Securities and Futures Ordinance.

(1) It shall be the duty of a recognized exchange company to ensure-

(a) so far as reasonably practicable, an orderly, informed and fair market-

(i) in the case of a recognized exchange company which operates a stock market, in securities that are traded on that stock market or through the facilities of that company; or

(ii) in the case of a recognized exchange company which operates a futures market, in futures contracts that are traded on that futures market or through the facilities of that company; and

(b) that risks associated with its business and operations are managed prudently.

(2) In discharging its duty under subsection (1), a recognized exchange company shall-

(a) act in the interest of the public, having particular regard to the interest of the investing public; and

(b) ensure that the interest of the public prevails where it conflicts with the interest of the recognized exchange company.