

Memo

To: **Canadian Securities Administrators**

Date: May 28, 2008

From: IIROC

Subject: **Application for Recognition of the Investment Industry Regulatory Organization of Canada ("IIROC")**

On behalf of IIROC, I am pleased to provide the response of the Investment Dealers Association of Canada ("IDA") and Market Regulation Services Inc. ("RS") to the comment letter on the application for recognition of IIROC received from the Investment Funds Institute of Canada ("IFIC") and egX Canada Inc. ("egX") (each dated March 7, 2008), and from Alpha Trading Systems Limited Partnership ("Alpha") dated March 18, 2008.

The IDA and RS welcome the support that IFIC and egX have expressed for the creation of IIROC, and the support that Alpha has expressed for the independence, fairness and impartiality of IIROC.

With respect to the matters raised in IFIC's comment letter, we agree that collaborative dialogue with industry representatives should be a critical element of IIROC's policy development process, and look forward to continuing to engage the industry in such consultations in connection with the current initiatives identified in IFIC's letter and future IIROC policy initiatives.

We also reaffirm our belief that the creation of IIROC will simplify and streamline the self-regulatory system and enhance its quality and effectiveness, in the manner described in the egX letter.

With respect to the Alpha letter, we note at the outset that many of Alpha's comments relate to existing features of the regulatory structure that are beyond the mandate of public comment on the merger proposal. We nevertheless acknowledge that these are issues that the CSA may well wish to consider in the appropriate context apart from the merger, and we would welcome the opportunity to discuss these issues with the CSA and affected market participants as the regulatory structure in Canada evolves.

Our responses to the specific points raised by Alpha are as follows:

Corporate Governance

Jurisdiction Over Non-Members: The Alpha letter suggests that IIROC may not have jurisdiction to regulate market participants that are not members of IIROC or representatives of IIROC members (i.e., ATS subscribers and their directors, officers and employees). IIROC's jurisdiction over such market participants will be on the same contractual basis as RS's current jurisdiction over them. With respect to market participants accessing a marketplace through "DMA" (dealer-sponsored direct access), in April 2007 RS's recognizing regulators and RS published for comment a proposal to amend the ATS Rules and UMIR to extend RS's jurisdiction to include the trading conduct of individuals and firms who are provided with dealer-

sponsored direct access to an exchange or ATS (other than pursuant to order execution accounts). These proposed amendments were open for public comment until July 2007, and IIROC looks forward to discussing the comments received with the CSA and to jointly determining whether changes to the original proposal are warranted in view of those comments and in consideration of international initiatives in this regard. In summary, we do not believe that membership in IIROC is a necessary condition for “consistent and effective regulation” of market participants under the ATS Rules.

Categorization of Marketplace Members: The differentiated status of exchanges and ATSS to which Alpha’s letter refers – in which ATSS (but not exchanges) are subject to both dealer and market regulation by IIROC – reflects the regulatory structure established by securities legislation and the ATS Rules. To the extent that any resulting “competitive advantage” accrues to exchanges, as suggested by Alpha, this is a function of that regulatory structure, and is not a result of the merger and creation of IIROC. We question whether any such competitive advantage arises, however. Marketplaces that are exchanges are also subject to additional regulatory oversight: under the ATS Rules provincial securities commissions regulate the activities of recognized exchanges while RS regulates trading activity on such exchanges.

IIROC Board of Directors

Buy-Side Representation: The creation of IIROC is intended to be an incremental development in the evolution of the self-regulatory structure in Canada, building on the existing jurisdiction of each of the IDA and RS. Buy-side entities are not currently members of either SRO, and will not be members of IIROC. The structure we adopted for the IIROC Board balances Non-Independent Directors (i.e., directors who are associated with IIROC members) and Independent Directors; we do not see what would be gained by creating a third category of buy-side directors that are neither associated with members nor considered independent. However, buy-side representation on the Board is very important to IIROC, as evidenced by the actual slate of initial directors. In addition, buy-side entities will have the opportunity to participate in IIROC’s policy development process through advisory committees. Finally, to take the view that individuals associated with buy-side entities are not “independent”, as advocated by Alpha, would reduce the pool of qualified Independent Directors without any corresponding public interest benefit.

TSX Representation: TSX’s governance rights in IIROC were the subject of extensive negotiation between IIROC and TSX, and subsequent correspondence and discussion between IIROC and the CSA, leading up to the publication of our application. TSX is agreeing to relinquish its 50% ownership interest and current governance rights in RS in return for (i) the right to recommend for nomination a Marketplace Director; and (ii) representation on the Finance and Audit Committee, only for so long as TSX meets the conditions set out in the TSX Regulation Services Agreement. This resolution was essential to IIROC attaining the “independence, fairness and impartiality” reflected in its governance structure which Alpha acknowledges and supports.

We also considered the option of providing representation on the IIROC Board to other marketplaces that achieve a threshold Market Share. The IIROC Board balances the number of Independent and non-Independent Directors, as well as the number of Dealer Directors and Marketplace Directors. For each new Marketplace Director, maintaining this balance would require the addition of a Dealer Director and *two* Independent Directors, increasing the size of the Board by *four* members. We believe that we should try to keep the Board to a more manageable size. We can, in practice, deal with the situation posited by Alpha and are committed to revisiting the issue in the event that this hypothetical situation becomes a reality.

Market Share Calculation: We acknowledge and agree with Alpha's drafting note and have amended the definition of Market Share in IIROC's By-law No. 1 by adding the underlined text below:

"Market Share" means the proportion of trading activity of any particular Marketplace of the trading activity of all Marketplaces with respect to exchange-traded securities other than derivatives and foreign exchange-traded securities other than derivatives calculated as to one-third by trading value, one-third by trading volume and one-third by number of trades, all in the immediately preceding calendar year calculated in accordance with guidelines approved by the Board. In the event of a dispute as to the calculation, and following consideration by management and the Board of IIROC, the matter will be reported to the relevant members of the Canadian Securities Administrators (or any successor thereof).

Fees

Marketplace Member Fees: We believe that the principle that IIROC operate on a cost-recovery basis is sound. Alpha's letter expresses a concern that IIROC's fee model for Marketplace Members will implement this principle in such a manner as to allow "differentiated fees for the same trade depending upon the marketplace where such a trade is executed". We understand the concern and agree that regulatory cost structures should not dictate decisions regarding trading venues. We would note that any proposal for UMIR regulation fees will be published for public comment and subject to the approval of the recognizing regulators. Alpha will therefore have the opportunity to review future fee model proposals and raise any concerns it might have in that context.

TSX Technology Services Agreement: The services provided to IIROC by TSX under the Technology Services Agreement will be provided on a cost plus 15% basis (as is currently the case). The draft agreement has been provided to the CSA in advance of the merger for their review, and the pricing arrangement is also subject to CSA review. The provision of the above-noted services on this basis should be distinguished from IIROC's provision of UMIR regulation services to TSX and its affiliated marketplaces. We do not agree that these arrangements result in "lower regulatory fees" for TSX. With respect to making the agreement public, we believe that CSA oversight of IIROC's technology arrangements with TSX should provide an adequate check as to the manner in which potential conflicts of interest are being addressed.

Regulation Services Agreements

Each Regulation Services Agreement ("RSA") that IIROC enters into with a marketplace reflects the unique business and trading model of that marketplace. This information, as well as many of the terms of the RSA itself, may constitute confidential business information of the marketplace, or confidential regulatory information of IIROC relating to the regulatory program for that marketplace. IIROC will continue RS's current practice of posting on its website a summary of each RSA describing the market regulation services that RS provides to the marketplace. In addition, all RSAs are filed with the CSA and subject to their regulatory oversight.