



**CANADIAN SECURITIES ADMINISTRATORS NOTICE OF AMENDMENTS TO
NATIONAL INSTRUMENT 21-101 MARKETPLACE OPERATION AND NATIONAL INSTRUMENT 23-101
TRADING RULES**

I. INTRODUCTION

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

1. National Instrument 21-101 *Marketplace Operation* (NI 21-101) and related Companion Policy 21-101CP (21-101 CP); and
2. National Instrument 23-101 *Trading Rules* (NI 23-101) and related Companion Policy 23-101CP (23-101 CP).

The key part of the Amendments introduces a framework to require all visible, immediately accessible, better-priced limit orders to be filled before other limit orders at inferior prices, regardless of the marketplace where the order is entered (Order Protection Rule or trade-through rule). Other parts of the Amendments include a prohibition on intentionally locking or crossing markets, and changes to marketplace technology requirements, clock synchronization, and information processor requirements.

We note that the best execution reporting requirements for marketplaces and dealers are not going forward at this time. We intend to republish these proposed amendments and when we do, we will include a summary of the comments received in response to our questions related to these proposed requirements and our responses. We also note that we have replaced the term “trade-through protection” with “order protection” but have not changed the underlying concept.

Subject to Ministerial approval requirements, the Amendments, other than those relating to the Order Protection Rule (i.e. other than changes to Part 6 of NI 23-101), will come into force on January 28, 2010 in all CSA jurisdictions. The Order Protection Rule will come into effect on February 1, 2011. Additional information regarding the implementation or adoption of the instruments in each province or territory is included in Appendix A to this Notice.

In Ontario, the Amendments were delivered by the Ontario Securities Commission (OSC) to the Minister of Finance for approval on November 13, 2009. We note that a blackline indicating the Amendments may be found on various Commission websites.

Until the Amendments relating to the Order Protection Rule come into force, we expect participants, as defined in the Universal Market Integrity Rules (UMIR) of the Investment Industry Regulatory Organization of Canada (IIROC) to comply with UMIR 5.2 *Best Price Obligation* (UMIR Best Price Rule).

II. BACKGROUND

On July 22, 2005, the CSA published Discussion Paper 23-403 *Market Structure Developments and Trade-through Obligations* (2005 Discussion Paper).¹ The purpose of the 2005 Discussion Paper was to discuss evolving market developments and the consequential implications for the Canadian capital market, and in particular the obligation to avoid trade-throughs (order protection).

The 2005 Discussion Paper asked a number of questions to get feedback on what values and rules were important to Canadian market participants. Because of the importance of the issues relating to order protection and their impact on the Canadian capital market, the CSA held a public forum on October 14, 2005 to permit all interested parties to participate in discussions relating to order protection.²

¹ See (2005) 28 OSCB 6333 for background.

² The transcript of the trade-through forum is published on the OSC website at:
http://www.osc.gov.on.ca/documents/en/Securities-Category2/rule_20051014_23-403_trade-through-forum.

The CSA received feedback on a number of issues identified in the 2005 Discussion Paper where there was often no clear majority opinion and the views on either side of a given issue were split. However, the majority of commenters stated that they believed that all visible orders at a better price should trade before inferior-priced orders.

On April 20, 2007, the CSA along with Market Regulation Services Inc. or RS (now IIROC) published the *Joint Notice on Trade-Through, Best Execution and Access to Marketplaces* (Joint Notice).³ The Joint Notice outlined a proposal for an order protection regime.⁴

On October 17, 2008, the CSA published proposed amendments to NI 21-101 and NI 23-101 and the related companion policies (collectively, the 2008 Proposed Amendments).⁵ The CSA invited public comment on all aspects of the 2008 Proposed Amendments. Eighteen comment letters were received. 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 and our responses to them, are attached as Appendix B to this Notice.

In February 2009 the CSA formed an industry implementation committee (Implementation Committee) made up of interested parties representing marketplaces, dealers, vendors and buy side investors to assist in identifying and providing recommendations to the CSA and, where appropriate, to IIROC with respect to operational issues associated with the Order Protection Rule. Over 30 industry members have participated in this open committee. As part of its work, the Implementation Committee created sub-committees to discuss and make recommendations in five areas it believed could result in material changes to the rule. The recommendations of each sub-committee were presented to the Implementation Committee who then provided a report to the CSA. The Report of the Implementation Committee Regarding Potential Material Changes to the Proposed Trade-through Protection Rule (Implementation Committee Report) is attached as Appendix C to this Notice. We would like to thank all Implementation Committee members for their time and valuable contribution. We would especially like to thank Judith Robertson, Chair of the Implementation Committee.

III. ORDER PROTECTION RULE

1. What is Order Protection?

Order protection or trade-through protection, ensures that all immediately accessible, visible, better-priced limit orders are executed before inferior-priced limit orders and are not traded through. It is an obligation owed by all marketplace participants to the market as a whole. Many commenters on the 2008 Proposed Amendments indicated that they believe in the importance of an order protection obligation. Unlike the obligation for best execution, the obligation not to trade-through is not a fiduciary duty and cannot be waived.⁶ Order protection applies whenever two or more marketplaces with protected orders are open for trading.

2. Why is Order Protection Important?

In a multiple marketplace environment, the assurance that better-priced orders will be filled ahead of inferior-priced orders is essential to maintain investor confidence and fairness in the market. Order protection is especially important to ensure the future participation of retail investors that have an historical expectation of such protection. Without such protection, there may not be sufficient incentive to contribute to the price discovery process because investors who disclose their intentions are not assured of the benefit of having their better-priced orders filled while others are able to use this information in their trading decisions. In addition, investors, including retail investors, may lose confidence that their orders are being treated fairly. This in turn, may contribute to the perception that an unlevel playing field exists providing certain participants with advantages over others. Such a perception may ultimately result in the removal of investors from the market.

The CSA believe that it is important that participants of all kinds, especially retail investors, should have confidence in the fairness and integrity of the Canadian market. They should be confident that when they enter an order on a marketplace their order will be treated fairly irrespective of the sophistication of the participant or the size of the order. Such confidence encourages greater participation from all types of investors which in turn increases liquidity in the

³ (2007) 30 OSCB (Supp-3).

⁴ The Joint Notice also included proposed rule changes regarding access to marketplaces and proposed rule changes regarding best execution. The CSA published the amendments to best execution in their final form on June 20, 2008, and again on September 5, 2008, to be effective on September 12, 2008. We intend to re-examine the proposed rule amendments relating to direct market access and republish them for comment in 2010.

⁵ (2008) 31 OSCB 10033.

⁶ For a discussion about trade-through and best execution, please see the notice that accompanied the 2008 Proposed Amendments (2008) 31 OSCB at p. 10039.

market and promotes a more efficient price discovery process. As a result, the CSA believe that order protection is an essential component to the integrity of the Canadian market.

3. The Current Regulatory Regime

Currently in Canada, order protection is addressed in IIROC's UMIR Best Price Rule. The UMIR Best Price Rule requires dealers when trading on marketplaces in Canada to use reasonable efforts to obtain the best price available for their trades. Under the UMIR Best Price Rule, dealers are required to introduce and comply with policies and procedures outlining how they will meet their best price obligations. There are a number of exemptions available and the factors to be considered in determining if reasonable efforts have been used are broadly outlined.⁷

The UMIR Best Price Rule currently applies only to dealers, which results in different requirements for dealers and non-dealers who are subscribers of alternative trading systems (ATSs). In addition, the rule currently does not provide the necessary infrastructure to effectively prevent trade-throughs. For example, it does not provide for a framework that would allow marketplace participants to simultaneously route orders to more than one marketplace.

IIROC will be revoking the UMIR Best Price Rule when the Order Protection Rule comes into effect. For details, please see IIROC Notice 09-0328 *Provisions Respecting Implementation of the Order Protection Rule*. Until then, the CSA expects participants to comply with the UMIR Best Price Rule.

4. The Proposed Order Protection Rule

This section outlines the key parts of the Order Protection Rule.⁸ It identifies where changes have been made and describes the view of the Implementation Committee and our responses.

(a) Key Aspects of the Order Protection Rule

(i) Marketplace Obligation

The Order Protection Rule requires each marketplace to establish, maintain and ensure compliance with written policies and procedures that are reasonably designed to prevent trade-throughs on that marketplace. Marketplaces are required to regularly review and monitor the effectiveness of their policies and procedures and act promptly to remedy any identified deficiencies. The purpose of this approach is to require marketplaces to eliminate trade-throughs that can reasonably be prevented, but also provide them with flexibility about how to do so. Marketplaces may choose to implement the obligation in various ways including, for example, voluntarily establishing direct linkages to other marketplaces, rejecting orders, re-pricing orders, or designing specific trade execution algorithms. However, marketplaces are not able to avoid their obligations by establishing policies and procedures that require marketplace participants to take steps to reasonably prevent trade-throughs.

As part of the policies and procedures required under the Order Protection Rule, marketplaces are required to have policies and procedures relating to their automatic functionality and how they will handle failures, malfunctions or material delays experienced by other marketplaces. In addition, a marketplace is required to immediately inform all regulation services providers, any information processor (or any information vendor if no information processor exists), its marketplace participants, and all other marketplaces when it experiences a failure, malfunction or material delay of its systems or equipment or its ability to disseminate order and trade data.⁹ It is also required to have policies and procedures that will outline how it will treat directed-action orders (see below for details on the directed-action order).

A marketplace is expected to show the effectiveness of its policies and procedures when evaluated by regulatory authorities by maintaining relevant information. This information would include how the marketplace evaluates its policies and procedures, any issues found and how issues were resolved.¹⁰

A marketplace is required to provide its policies and procedures, and any amendments thereto, to the securities regulatory authority and its regulation services provider 45 days prior to implementation. The CSA may be willing to grant an exemption to the 45 day time frame if appropriate.

⁷ See UMIR Rule 5.2 *Best Price Obligation* and the related policy.

⁸ The Order Protection Rule was previously referred to as the "trade-through protection rule" in the 2008 Proposed Amendments.

⁹ Section 6.3 of NI 23-101.

¹⁰ Section 6.1 of NI 23-101 and section 6.2 of 23-101CP.

(ii) *Protected Orders*

Order protection only applies to a protected order which is an order to buy or sell an exchange-traded security, other than an option, that is displayed on a marketplace that provides automated functionality and about which information is required to be provided to an information processor or information vendor.¹¹ The CSA do not consider special terms orders that are not immediately executable or that trade in a special terms book, such as all-or-none, minimum fill, or cash or delayed delivery, to be orders that are protected.¹² However, those executing against these types of orders are required to execute against all better-priced orders first.

A marketplace that is considered to provide “automated functionality” offers the ability to immediately and automatically:

- permit an incoming order entered on the marketplace electronically to be marked as immediate-or-cancel,
- execute an immediate-or-cancel order,
- cancel unexecuted portions of that order,
- transmit a response to the sender indicating the action taken, and
- display information that updates the displayed orders on the marketplace.¹³

We note that we have changed the name for the marker of an order in the definition of automatic functionality in the 2008 Proposed Amendments from “fill-or-kill” to “immediate-or-cancel” to reflect industry standards.

(iii) *Visible Orders*

The Order Protection Rule only applies to orders or parts of orders that are visible. For an order to be protected, it must be displayed by a marketplace and information about it must be provided to an information processor or information vendor.

Hidden orders or those parts of iceberg orders that are not visible are not protected under the Order Protection Rule. Currently, the non-visible or “dark” portions of orders can be avoided in a transparent order book through the use of the “bypass” marker introduced by IIROC.¹⁴ The bypass marker signals to the marketplace that the order routed to the marketplace should not execute against any hidden liquidity. The bypass marker can be used with the directed-action order exception described below.

(iv) *Full Depth-of-book*

The Order Protection Rule will maintain the existing standard in the UMIR Best Price Rule and apply to all visible orders and visible parts of orders entered into the book (i.e. full depth-of-book). This means that in order to execute an order at an inferior price, a marketplace, or a marketplace participant using a directed-action order, has to ensure that all protected orders that are visible at better price levels have been executed. This approach is different from the one adopted in Regulation NMS in the United States, which provides protection only to the best bid and offer on each trading center (top-of-book).¹⁵

The Implementation Committee was divided on whether or not the CSA should move from full depth-of-book to a different level of protection. Although the Implementation Committee agreed that depth-of-book protection was more complete and philosophically consistent with the policy objectives of the CSA, the Implementation Committee did not reach a consensus on whether the incremental protection of full depth was sufficient to justify the incremental costs. In order to further investigate this issue, CSA staff provided the Implementation Committee members with specific questions designed to obtain information regarding the costs associated with full depth protection over top-of-book protection. These questions and a summary of the responses received are attached as Appendix D.

We have reviewed the information received from the Implementation Committee and gathered throughout this process to determine whether to maintain full depth order protection or to move to a top-of-book standard. Specifically, we reviewed the comments received in response to the 2005 Discussion Paper, the Joint Notice, and the 2008 Proposed Amendments, and the submissions made for top-of-book and depth-of-book in the Implementation Committee recommendations, and the responses to the questions provided to the Implementation Committee

¹¹ Definition in section 1.1 of NI 23-101.

¹² See subsection 5.1(3) of 21-101CP.

¹³ Section 1.1 of NI 23-101.

¹⁴ See IIROC Market Integrity Notice 2008-008 published on May 16, 2008.

¹⁵ Regulation National Market System, Section 242.611, Final Rule, Federal Register 124 (June 29, 2005) pp. 37620-37632.

(marketplaces, dealers, buy side investors, and vendors). While we recognize that some have the view that a top-of-book standard should be adopted, we note:

- A review of commenters who responded to the 2005 Discussion Paper and the Joint Notice showed a majority were in support of order protection that would apply to all visible orders regardless of where they are in the book. The majority of the comments received to the 2008 Proposed Amendments were also in favour of a full depth standard however, some commenters expressed different opinions on how many levels of the book should be protected under the rule.
- There was no clear consensus from the Implementation Committee on whether to maintain full depth protection or adopt top-of-book protection.
- The responses to the CSA's informal questions of the members of the Implementation Committee showed a majority who said that there were few incremental costs associated with full depth-of-book protection when compared to top-of-book. There was also no consensus on whether there may be an increased cost of latency associated with full depth protection.

The CSA have decided to maintain full depth-of-book protection. We believe the policy objectives of investor confidence in the fairness and integrity of the market are more effectively accomplished through full depth protection. We believe that it is important for investors, including retail investors, to know that any order they enter on a marketplace will be executed before an inferior-priced order. We also believe that shifting the current level of protection in Canada to a top-of-book obligation may be perceived as adopting a lower level of investor protection.

Several members of the Implementation Committee identified the potential for higher costs with full depth over top-of-book protection such as the cost of retaining a greater volume of data in order to show compliance with the Order Protection Rule. The CSA do not currently expect that demonstrating compliance with the Order Protection Rule will be materially different from showing compliance with dealers' best execution and best price obligations. We will be working with IIROC to develop our expectations regarding what information will need to be maintained by marketplaces and marketplace participants that choose to use the directed-action order. This expectation will be outlined in a staff notice.

(v) Anti-Avoidance

We have included an anti-avoidance provision that prohibits a person or company from routing orders to foreign marketplaces only for the purpose of avoiding the order protection regime in Canada.¹⁶ In its report, the Implementation Committee recommended that any provision that required participants to execute better-priced orders in Canada before executing on foreign marketplaces should be limited to large, pre-arranged trades. As a result, IIROC will be publishing concurrently with this Notice amendments to UMIR to address this issue.¹⁷

We note however, that while marketplace participants are not required to assess foreign markets under the Order Protection Rule, they should consider foreign markets when addressing their best execution obligation.

(b) "Permitted" Trade-throughs

The overall purpose of order protection is to promote confidence and fairness in the market where the visible portion of better-priced limit orders trade ahead of inferior-priced orders. It is important to acknowledge, however, that the issues relating to preventing all trade-throughs in a multiple marketplace environment have become highly complex, particularly with the advent of new order types and other market structure developments in Canada.

As a result, we have included a number of circumstances where trade-throughs are permitted.¹⁸ These "permitted" trade-throughs or "exceptions" are primarily designed to achieve workable inter-market order protection while facilitating the use of trading strategies and order types that are useful to investors. They are intended to promote fairness, innovation and competition. A marketplace or marketplace participant must have policies and procedures that outline in what circumstances they may rely on the exception and how such reliance will be evidenced.

(i) Failure, Malfunction or Material Delay of Systems or Equipment or its Ability to Disseminate Marketplace Data (Systems Issues Exception)

¹⁶ Section 6.7 of NI 23-101.

¹⁷ On October 27, 2008 IIROC published a concept proposal respecting conditions on the conduct of trade on a foreign organized regulated market as part of IIROC Rules Notice 08-0163.

¹⁸ The list of "permitted" trade-throughs is set out in section 6.2 of NI 23-101.

We are including an exception for any failure or malfunction or material delay of a marketplace's systems or equipment or ability to disseminate data (systems issues).¹⁹ The intention of the Systems Issues Exception is to provide marketplaces and marketplace participants with flexibility when dealing with another marketplace that is experiencing a systems problem (either of a temporary nature or a longer-term issue). A marketplace that is experiencing a failure, malfunction, or material delay of its systems, equipment or ability to disseminate data is responsible for informing all other marketplaces, its marketplace participants, any information processor, and any regulation services providers when the failure, malfunction or material delay occurs.²⁰

If a marketplace fails repeatedly to provide an immediate response to orders received or there are material delays in the response time, and no notification has been issued by the marketplace that may be experiencing systems issues, a routing marketplace or a marketplace participant may rely on paragraph 6.2(a) or 6.4(a)(i) of NI 23-101, in accordance with its policies and procedures that outline processes for dealing with these systems issues. This allows for the flexibility that is necessary to deal with concerns about potential issues that arise because of latency. In these circumstances, the marketplace or marketplace participant must immediately notify the marketplace that may be having systems issues, its own marketplace participants (where applicable), any information processor, and all regulation services providers. This notification will alert a marketplace to the fact that it may be experiencing systems issues and help the marketplace in verifying whether this is true.

In the next few months, we expect to consult with industry and examine a number of implementation issues associated with the Systems Issues Exception including the parameters around the notification procedures and protocols.

(ii) Directed-Action Order

We have included an exception that informs a marketplace that if it receives a specific order type, it can immediately carry out the action specified by the sender without delay or regard to any other better-priced orders displayed by another marketplace.²¹ We have changed the name of this order from an inter-market sweep order to a directed-action order (DAO).²² We have also provided an exception for when simultaneous DAOs are sent.²³ In response to recommendations made by the Implementation Committee, the Amendments clarify the responsibilities of a marketplace and a marketplace participant when using the DAO. An order can be marked "DAO" by a marketplace or a marketplace participant. The marker, as its name suggests, allows for multiple actions to be taken. It may be sent to instruct the receiving marketplace to immediately execute and cancel, or immediately execute and book any remainder of the order. In addition, a DAO may be sent to instruct the receiving marketplace to book as a passive order awaiting execution.

To avoid interaction with hidden liquidity, the DAO may also be used in conjunction with the bypass marker, as defined in IIROC's UMIR. Regardless of whether a DAO uses the bypass marker, the sender is responsible for executing against all better-priced visible orders before executing at an inferior price. If a DAO is sent without the bypass marker and interacts with hidden liquidity, all better-priced visible orders must be taken out before executing at an inferior price.

The definition of a DAO allows for the simultaneous routing of more than one DAO in order to execute against protected orders. In addition, marketplace participants may send a single DAO to execute against the best protected bid or best protected offer. A DAO may enable participants to execute large block orders, provided that they simultaneously route one or more DAO's to execute against better-priced orders. This would facilitate compliance with the order protection obligation. Whenever a market participant uses a DAO, it must have policies and procedures outlining its use and be able to show compliance with its policies and procedures regarding its use.

The Implementation Committee recommended that the requirements be set out more specifically when marketplace participants choose to assume the responsibility for order protection compliance. Although this expectation was outlined in the policy, in response to the Implementation Committee's request, we clarified the obligation in subsection 6.4 of NI 23-101 which requires a marketplace participant to establish, maintain and ensure compliance with written policies and procedures that are reasonably designed to prevent trade-throughs before using a DAO.

¹⁹ Paragraphs 6.2(a) and 6.4(a)(i) of NI 23-101.

²⁰ Paragraph 6.3(1) of 23-101CP.

²¹ Paragraph 6.2(b) of NI 23-101.

²² Definition in section 1.1 of NI 23-101.

²³ Paragraphs 6.2(c) and 6.4(a)(ii) of NI 23-101.

(iii) *Changing Markets Exception*

With the emergence of electronic trading, market conditions are changing and moving more rapidly with each new innovation in technology. The number of orders entered for every trade executed has increased dramatically in recent years. This means that the quoted price of a security can often change more quickly than the rate at which a trader can respond. As a result, we are allowing for a transaction that occurs when the marketplace displaying the best price that was traded through had displayed, immediately prior to executing a trade that resulted in a trade-through, an order with a price that was equal or inferior to the price of the trade-through transaction.²⁴ This exception is meant to provide some relief due to rapidly moving or changing markets.

The Implementation Committee recommended that a look-back exception be adopted where marketplaces could print a pre-arranged trade outside the national best bid or offer (NBBO) at the time of the print as long as: (a) the price was within the NBBO at the time the trade was agreed to, and (b) the trade is printed by a marketplace within 10 seconds of when the parties agreed to the trade.

The CSA have responded by clarifying that the “changing markets” exception²⁵ addresses the Implementation Committee’s concern regarding the latency involved when executing manual trades.

The “changing markets” exception allows for the execution of an order on a marketplace, within the best bid or offer on that marketplace but outside the best bid or offer displayed across all marketplaces in certain circumstances. The exception allows a trade-through to occur when an order has been sent to execute against the best protected bid or offer on a marketplace but by the time it is executed the best bid or offer across marketplaces has changed. The exception also permits a trade that has been agreed to off-marketplace (where a check has been performed to see if the negotiated price can be executed within the best bid or offer across marketplaces) to be traded when the best bid or offer displayed on another marketplace has changed before the trade is executed (i.e. printed) on the marketplace.

In Canada, the execution of orders of exchange-traded securities is only permitted to occur off-marketplace in a very limited number of circumstances. These circumstances are described in UMIR 6.4.²⁶ Negotiated trades that occur off-marketplace are not considered executed until they are printed on a marketplace. The “changing markets” exception will also facilitate the printing of manual trades after they have been agreed to in the context of the market, but may be outside of the market when they are entered on a marketplace.

However, the exception is not meant to change trading practices in Canada and allow for off-marketplace trading and reporting. Matched orders are considered to be executed only if they have been executed within the context of the marketplace on which the order is printed.

(iv) *Non-Standard Orders*

Non-standard orders have been included on the list of “permitted” trade-throughs. A non-standard order refers to an order for the purchase or sale of a security that is subject to non-standard terms or conditions relating to settlement that have not been set by the marketplace on which the security is listed or quoted.²⁷ A marketplace participant, however, may not add a special settlement term or condition to an order solely for the purpose that the order becomes a non-standard order so that it qualifies for an exception to the Order Protection Rule.

(v) *Calculated-Price Order*

We have included an exception for orders where the price is not known at the time of order entry and is not based, directly or indirectly, on the quoted price of the security at the time the commitment to execute the order was made.²⁸ We note that the language of the 2008 Proposed Amendments has been changed to more clearly describe the order. Orders that are included under this definition are:

²⁴ Paragraphs 6.2(d) and 6.4(a)(iii) of NI 23-101.

²⁵ Formerly known as the “flickering order” exception.

²⁶ Trades are permitted to occur off-marketplace if the trade is: an unlisted or non-quoted security, has received a regulatory exemption, to adjust an error, executed on a foreign organized regulated market, executed outside of Canada provided that the trade is reported appropriately, is the result of certain terms of the security, is the result of the exercise of an option, right, warrant or similar pre-existing contractual agreement, pursuant to a prospectus or exempt distribution, or is in a listed security that has been halted, delayed, or suspended.

²⁷ Subparagraphs 6.2(e)(i) and 6.4(a)(iv)(A) of NI 23-101.

²⁸ Subparagraphs 6.2 (e)(ii) and 6.4(a)(iv)(B) of NI 23-101.

- call market orders – where the price of a trade is calculated by the trading system of a marketplace at a time designated by the marketplace,
- opening orders – where each marketplace may establish its own formula for the determination of opening prices,
- closing orders – where execution occurs at the closing price on a particular marketplace, but at the time of order entry, the price is not known,
- volume-weighted average price orders – where the price of a trade is determined by a formula that measures a weighted average price on one or more marketplaces, and
- basis orders – where the price is based on prices achieved in one or more derivative transactions on a marketplace. To qualify as a basis order, this order must be approved by a regulation services provider or exchange or quotation and trade reporting system that monitors the conduct of its members or users respectively.²⁹

(vi) *Closing-Price Order*

We have included an exception for an order entered on a marketplace for the purchase or sale of an exchange-traded security that executes at the established closing price on that marketplace for that trading day for that security.³⁰ Some marketplaces provide an after-hours trading session at a price established by that marketplace during its regular hours for marketplace participants who are required to benchmark to a certain closing price. Therefore, we have included an exception for trade-throughs resulting from the execution of transactions in these circumstances so that a better-priced order on another marketplace does not need to be accessed.

(vii) *Crossed Market*

We have included an exception for a trade-through that occurs when the best protected bid was higher than the best protected offer (crossed market).³¹ Without this exception, no marketplace could execute transactions in a crossed market because it would constitute a trade-through. The CSA recognize that crossed markets may occur as a result of order protection only applying to displayed orders or parts of orders, and not to hidden or reserve orders. Intentionally crossing the market to take advantage of this exception would be a violation of section 6.5 of NI 23-101.

(c) Fair Access to Marketplaces

We have made amendments to 21-101CP to enhance the fair access provisions in NI 21-101.³² Rather than setting a threshold for ATSS to permit access to all marketplace participants, the provisions require marketplaces to provide fair access to all of their services relating to order entry, trading, execution, routing and data. As well, marketplaces should permit fair access to their services for the purpose of complying with order protection requirements.

With respect to non-member/subscriber access to a marketplace, our view is that a marketplace should not be required to provide direct access to non-members/subscribers. It will be left to the marketplaces to determine how best to meet their order protection obligations. In the 2008 Proposed Amendments, we asked for comments on the various alternatives available to a marketplace to route orders to another marketplace. Certain commenters suggested that one option was for marketplaces to be directly linked by marketplaces becoming members or subscribers of all marketplaces that display protected orders through dealer entities. Other commenters suggested other options including that ATSS should be allowed to route orders to an exchange without being required to become a participating organization of the exchange, utilize an in-house or related-party capability to smart order route, licence a stand alone third party capability to smart order route, and price improve the order to a non-offending price level or reject a potentially offending order. In the next few months, we intend to consult with industry to discuss other issues relating to access.

(d) Trading Fee Limitation

In the 2008 Proposed Amendments, we proposed a principles-based trading fee limit. We asked for comments on whether the CSA should set an upper limit on fees charged to access an order for order protection purposes and if so, what this limit should be. Commenters were divided. Several expressed the view that an upper limit on fees should be set but there was no consensus what this limit should be. Others believed that a strict fee cap should not be set and that the issue would be addressed by market competition. We note that a trading fee is defined as “a fee

²⁹ Section 1.1.3 of NI 23-101CP.

³⁰ Subparagraphs 6.2(e)(iii) and 6.4(a)(iv)(C) of NI 23-101.

³¹ Paragraphs 6.2(f) and 6.4(v) of NI 23-101.

³² Sections 7.1 and 8.2 of 21-101CP.

that a marketplace charges for the execution of a trade on that marketplace.”³³ It would include any fee charged to access an order, but does not include fees charged for routing or data dissemination.

In its report, the Implementation Committee concluded that it was advisable to include a trading fee limitation as part of the proposed rule. While divided on a specific cap, the Implementation Committee recommended that the CSA should consider adopting the model used in the United States that defines a set fee cap for stocks trading above \$1, and a percentage of the value of the trade, for stocks trading below \$1.

The CSA considered at great length whether to move from a principles-based approach to prescribing a specific trading fee cap. In our consideration, the following difficulties were identified in choosing a fee cap:

- When setting a trading fee as an amount per share, the fee will be a higher percentage of the transaction value for lower priced stocks than for those with higher prices.
- Dictating that fees should be charged on a cents per share or percent of value basis could limit the ability of marketplaces to implement innovative fee structures.
- The Canadian market has a higher proportion of stocks that trade below \$1 than in the U.S. and so simply implementing the U.S. fee model could have unanticipated implications. For example, setting the maximum allowable trading fee as a percent of value could unduly impact the viability of Canada’s junior markets.

As a result, the CSA have decided to maintain taking a principles-based approach and not set a specific trading fee cap. Set out below is a three pronged approach that will be taken with respect to fees to prevent marketplaces from raising their fees to take advantage of the order protection regime and to address issues raised by the Implementation Committee.

a) Proposed Provision: The Order Protection Rule prohibits a marketplace from imposing a term for the execution of an order that has the effect of discriminating between orders that are routed to that marketplace and orders that are entered on that marketplace.³⁴

b) Current Requirements: Sections 5.1 and 6.13 of NI 21-101 currently require marketplaces to not unreasonably prohibit, condition or limit access by a person or company to services offered by it. This includes limiting or conditioning access through the imposition of an unreasonable fee or fee model. In assessing whether such a barrier to access may exist, the marketplace should consider a number of factors including:

- the value of the security traded,
- the amount of the fee charged relative to the value of the security traded,
- the amount of fees charged on other marketplaces, and
- with respect to market data fees, the amount of market data fees charged relative to the market share of the marketplace.

Concern was expressed by the Implementation Committee that a prohibition on marketplaces from imposing trading fees that are equal to or greater than the trading increment defined in UMIR could imply that any trading fee up to the trading increment is reasonable. In fact, the intention of the provision was not to set the fees charged by marketplaces, but to preserve the integrity of the Order Protection Rule. Therefore, to address the issue of maintaining the policy goals of the Order Protection Rule, we have added a fifth factor in 21-101CP³⁵ that a marketplace should consider when determining if its fees unreasonably prohibit, condition or limit access to its services. In addition, we have maintained in 21-101CP that a trading fee greater than or equal to the minimum trading increment as defined in UMIR would unreasonably limit access to a marketplace’s services as it would be inconsistent with the policy goals of order protection.

c) Letter to Marketplaces: In order to ensure that the fees that are currently charged by marketplaces in Canada do not unreasonably condition or limit access to their services, we will be asking all marketplaces to explain and justify their current fees and fee models and any changes made to their fees going forward prior to implementation to demonstrate that they are in compliance with NI 21-101.

³³ Section 1.1 of NI 21-101.

³⁴ Subsection 10.2 of NI 21-101.

³⁵ Subsections 7.1(4)(e) and 8.2(4)(e) of 21-101CP.

(e) Locked and Crossed Markets

A “locked market” occurs when there are multiple marketplaces trading the same security and a bid (offer) on one marketplace is posted at the same price as an offer (bid) on another marketplace. Had both orders been entered onto the same marketplace the bid and the offer would have matched and a trade would have been executed. There are two ways for a locked market to be unlocked:

- typically, more buyers and sellers appear resulting in subsequent trades and immediate correction; or
- one of the participants involved in the lock removes its order and places the order on another marketplace to immediately execute the trade.

In contrast, a “crossed market” occurs when one participant’s bid (offer) on one marketplace is higher (lower) than another participant’s offer (bid) on a different marketplace. A crossed market condition between marketplaces usually does not last for a long period of time as someone will usually take advantage of the arbitrage opportunity.

While market participants agree that intentionally crossing markets should be prohibited, some argue that locking the market philosophically represents the most efficient market by eliminating the bid-ask spread. Others argue that locking the market creates confusion as market participants, including investors, do not understand why a displayed order is not being executed if there is an opposite order posted on another marketplace at the same price. Such confusion may impact the perception of the efficiency and fairness of the Canadian market which may in turn impact confidence levels and discourage participation. In addition, if the trader locking the market is acting as agent for her client, locking the market instead of executing the order could be a violation of best execution obligations.

In the view of the CSA, the practice of intentionally locking or crossing the market may detract from market efficiency, lead to a perception of a lack of market integrity, and may create investor confusion. We think that if there is a posted order at which price the participant is willing to trade, that order should be executed. Furthermore, the prohibition could encourage more interaction between buyers and sellers and encourage the use of limit orders (by offering some protection to the first displayed order).

Section 6.5 of NI 23-101 prohibits a marketplace participant from intentionally locking or crossing a market by entering a protected order to buy a security at the same price or higher than the best protected offer or entering a protected order to sell a security at the same price or lower than the best protected bid. This section is meant to capture the situation where a marketplace participant enters an order intentionally to lock or cross a particular marketplace or the market as a whole. It is not intended to prohibit the use of marketable limit orders. As mentioned in subsection 4(b)(vii) of this Notice, an exception from the Order Protection Rule has been provided to allow for the resolution of crossed markets that occur unintentionally. An exception is not necessary to resolve locked markets.

An example of when a marketplace participant intentionally locks the market is when a marketplace participant enters a locking order on a particular marketplace to avoid paying a fee charged by a marketplace or to take advantage of a rebate offered by a marketplace. As well, the CSA would consider an order marked DAO or the remainder of a DAO that is booked and that locks or crosses the market to be an intentional locking or crossing of the market and a violation of NI 23-101.

The CSA recognize that locked or crossed markets may occur unintentionally. An unintentional lock or cross could occur in the following circumstances:

- as a result of latency issues when a marketplace participant has routed multiple DAOs to a variety of marketplaces;
- when one of the marketplaces displaying an order that is involved in the lock or cross was experiencing a failure, malfunction or material delay of its systems, equipment or ability to disseminate marketplace data;
- when the order locking or crossing the market was entered when the market was already crossed; and
- when an order that is posted after all displayed liquidity has been executed against and a reserve order generated a new visible bid above the displayed offer or a new offer below the displayed bid.³⁶

IV. ADDITIONAL AMENDMENTS

Along with the Order Protection Rule, we have made additional amendments to NI 21-101 and NI 23-101.

³⁶ Subsection 6.4(2) of 23-101CP.

1. Marketplace Systems

A number of changes have been made to the system requirements for a marketplace in Part 12 of NI 21-101. Most of these changes update the technical descriptions of the requirements and modify the requirements to better reflect what is taking place in practice. They also address some of the concerns raised regarding standards for marketplaces.

Part 12 of NI 21-101 requires a marketplace to address specific issues related to capacity management, system development and testing, system vulnerabilities and business continuity. The amendments also require a marketplace to develop and maintain a more comprehensive and integrated concept of a system of internal control. The defined scope of the annual independent systems review (ISR) is to provide assurance on these same issues.

The Amendments have removed the threshold to exempt an ATS from conducting an ISR. ATSs are now required to engage a qualified party to conduct an annual independent systems review and prepare a report under subsection 12.2(1) of the Instrument. A regulator or the securities regulatory authority may consider granting an exemption from this requirement. An exemption may be granted provided that the marketplace prepare a control self-assessment and file it with the regulator. In determining whether to grant the exemption, a number of factors will be considered including: the market share of the marketplace, the timing of the last independent systems review, and changes to systems or staff of the marketplace.³⁷

Changes have also been made to the requirements for marketplaces to make available their technological requirements regarding interfacing with, or accessing the marketplace and, make available systems facilities for testing access. Before a new marketplace begins operations, it must make these requirements available for at least three months and offer systems testing for at least a two-month period. If the marketplace is already operating, all material changes to these requirements must be made available for a three-month period and offer testing to these systems for a two-month period.³⁸ In response to public comments, we have included some flexibility so that if a marketplace must make an immediate change to address a failure, malfunction or material delay to its systems or equipment, such a change can be implemented if the marketplace immediately notifies the regulator and its regulation services provider of its intention to make the change and make the amended technological requirements available as soon as practicable.³⁹

2. Transparency

Amendments have been made to Parts 9 and 10 of 21-101CP for the purposes of clarifying the requirements under sections 7.1, 7.2, 8.1 and 8.2 of NI 21-101 for marketplaces, inter-dealer bond brokers and dealers to provide accurate and timely order and trade information to an information processor, or to an information vendor that meets the standards set by a regulation services provider. Such information should not be made to any other person or company on a more timely basis than it is made to an information processor or information vendor.

3. Information Processor Requirements and Systems

We have made amendments to section 14.5 of NI 21-101 and Part 16 of 21-101CP regarding the technological requirements and obligations of an information processor. An information processor has similar requirements as marketplaces in this area including the ability to assess capacity management, system development and testing, system vulnerabilities and business continuity.⁴⁰

NI 21-101 requires an information processor to provide accurate, timely and fair collection processing and distribution of information for orders and trades in securities. The CSA expect that in meeting this requirement, an information processor will ensure that all marketplaces, inter-dealer bond brokers and dealers will be given access on fair and reasonable terms. In addition, we also expect that no preferential treatment will be given to those providing information or those receiving information. Information should not be provided on a more timely basis to a single person or company or group of persons or companies over others.⁴¹

As of July 1, 2009 TSX Inc. is the information processor for equity securities in Canada. CanPX is the information processor for corporate debt securities.

³⁷ Subsection 14.1(4) of 21-101CP.

³⁸ Subsections 12.3(1) and (2) of NI 21-101.

³⁹ Subsection 12.3(4) of NI 21-101.

⁴⁰ Subsection 14.5 of NI 21-101.

⁴¹ Subsection 16.1(3) of 21-101CP.

4. Amendments to Sections 7.2, 7.4, and 8.3 of NI 23-101 - Agreement Between a Marketplace and a Regulation Services Provider

Because of the development to multiple marketplaces operating in Canada, amendments have been made that ensure that information from all marketplaces will be provided to a regulation services provider so that it can effectively conduct cross market surveillance. Subsections 7.2(c), 7.4(c), and 8.3(d) require that the agreement between a regulation services provider and a marketplace mandates the marketplace to provide all information that a regulation services provider reasonably requires to effectively monitor the conduct of and trading by marketplace participants on and across marketplaces and the conduct of the marketplaces as applicable. This amendment in no way changes the existing relationship between an exchange or quotation and trade reporting system and the regulation services provider that it has retained. Instead, it clarifies our expectation that the regulation services provider will be provided with the information it needs to effectively monitor trading on multiple marketplaces and to facilitate monitoring to ensure that certain standards and obligations are uniformly met by all marketplaces that the regulation services provider surveils. These standards and obligations will include, at a minimum, monitoring clock synchronization, the inclusion of specific designations, symbols and identifiers, order protection requirements and audit trail requirements.⁴²

V. IMPLEMENTATION PERIOD

The Amendments, other than those relating to the Order Protection Rule, will become effective on January 28, 2010. The Amendments relating to the Order Protection Rule (Part 6 of NI 23-101, Part 6 of 23-101CP and the relevant definitions) will become effective on February 1, 2011. The difference in these dates reflects a transition period necessary for marketplaces and marketplace participants to be ready to implement the Order Protection Rule. We expect to provide further details regarding implementation in a separate notice to be published shortly.

VI. QUESTIONS

Questions may be referred to any of:

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⁴² Section 7.5 of 21-101CP.