

**ALBERTA SECURITIES COMMISSION NOTICE 22-701
NOTICE OF PUBLIC FORUM TO DISCUSS “NETS” AND
MARKET FRAGMENTATION**

Background

On May 16, 1997, the Ontario Securities Commission (the “OSC”) published a Request for Comments and Notice of Forum regarding Non-SRO Electronic Trading Systems (“Request for Comments”), (1997) 20 OSCB 2565. In the Request for Comments, the OSC indicated it was seeking information from interested parties (including stock exchanges, Non-Self Regulatory Organization Electronic Trading Systems (“NETS”), brokers, dealers and investors) and was intending to convene a public forum to develop an appropriate regulatory framework for the operation of NETS, and the role of the Commission in connection therewith.

The Alberta Securities Commission (the “ASC”), the British Columbia Securities Commission (the “BCSC.”), Commission des valeurs mobilières du Québec (the “CVMQ”), and the Saskatchewan Securities Commission (the “SSC”), notified the OSC that they would like to hold a joint forum where representatives of their respective Commissions would be present at the proceedings and would participate in the public meeting on the same basis as OSC Commissioners. The ASC, BCSC., CVMQ and SSC (together with the OSC, the “Commissions”) published the Request for Comments in each of their respective jurisdictions.

Twelve parties made submissions to the Commissions and the Commissions thank them for their contributions. A summary of the comments follows this notice.

The following sets forth information regarding the public forum to be held to seek additional guidance regarding the regulation of NETS and related issues.

Date and Location of Public Forum

The public forum to discuss NETS and related issues will be held on Thursday, April 23, 1998 in Toronto, in the Harry S. Bray Hearing Room, 8th Floor, 20 Queen Street West. Depending on the indications of interest regarding speaking at, and attending the forum, the location of public forum may change and further dates and places may be added. Participants will be notified of any changes.

Structure of the Public Forum

Commissioners from the ASC, BCSC., CVMQ, OSC and SSC will conduct the public forum and may ask questions of the presenters.

Presentations

Parties interested in making oral presentations should fill out and return the attached request form (the "Request Form") indicating an interest in making a presentation. Presenters will be allotted up to 60 minutes in which to make their presentations and respond to questions from the participating Commissioners. Consideration will be given to increasing the 60 minute limitation on a case by case basis where a presenter indicates that a longer period of time is required. Presenters should ensure that sufficient time has been set aside for responding to questions from the participating Commissioners. Presenters should indicate the amount of time required and any audio-visual aids requirements on the Request Form. In allotting time, priority will be given to those parties who have responded in writing to the Request for Comments. A transcript of the proceedings will be made. **Completed Request Forms must be submitted by March 27,1998.**

Confirmation of Presentation and Attendance

Those parties who have submitted a Request Form in accordance with this Notice will be provided with a confirmation of time of their presentation and the location of the forum.

Attendance of Public

The media and any other persons interested in attending the forum as observers are requested to fill out and return the Request Form indicating their interest in attending. Completed Request Forms must be submitted by March 27, 1998.

Specific Additional Guidance is Requested

The responses to the Request for Comments provide evidence of a considerable consensus on many areas but also identify some areas where a consensus is lacking. To assist the Commissions with their policy considerations and help participants focus their presentations, a list of topics and questions is set out in this Notice. The Commissions encourage presenters to address the following issues in their presentations and to provide corresponding written submissions.

A. AREAS OF CONSENSUS

Analysis of the responses to the Request for Comments provides evidence of considerable consensus on a number of issues.

- Competitive solutions reached through the operation of market forces are to be preferred over mandated solutions.
- A minimum framework must be provided to which all participants are subject. That

framework must be provided by, or at least blessed by, the legal authority of government.

- In addressing the minimum framework that should apply to the structure of the equities market in Canada, respondents agreed that upon execution, transactions must be reported on a timely basis for processing in a way that provides useful and easy access to market information for Canadian investors.
- NETS provide a desired service that should be fitted into the Canadian equities market.

By assuring a common language (meaning that transactions are denominated and conducted in Canadian currency), those bids, offers and transactions on NETS would be fitted into the Canadian market and:

- a) form part of the Canadian market transparency/price discovery scheme; and
- b) be integrated into whatever is determined to be the appropriate displacement model that assures “live” bids and offers of their entitlement to trade. For example:
 - (i) price priority/”trade-through” protection; and
 - (ii) secondary priority/sharing protocol based on time of entry or size.

How would a system operate if Canadian currency is not the mandated denomination for bids, offers and transactions facilitated by NETS for Canadian accounts by Canadian intermediaries ?

- **DISCLOSURE OF POST-TRADE AND PRE-TRADE INFORMATION ARISING FROM THE OPERATION OF MARKETS**

1. Timely Last Sale Reporting

All respondents proposed that transactions for Canadian accounts (through registered intermediaries) should be reported in a timely fashion, either:

- a) to a consolidator of information (e.g. the Toronto Stock Exchange now functions as a consolidator for distribution of Canadian market information outside of Canada with respect to bids, offers and transactions on Canadian exchanges); or
- b) to any market information vendor that wishes to have it.

The expectation would be that the equivalent of a “consolidated last sale tape”, would be

constructed from this data by the vendors or by a consolidator that would provide it to the vendors.

Is it necessary for the Commissions to set standards as to data protocols and timeliness of data production for this type of information, or will market forces provide an adequate response?

Should there be a formally appointed consolidator of market information? If so, what criteria should be used in selecting such a consolidator?

2. Availability of Pre-Trade Information

Most respondents held the view that "pre-trade information, concerning bids and offers that are "in the market" and available for execution should also be public information and handled in much the same way as post-trade information, i.e. provided to vendors on a timely basis.

NETS Markets: *Should bids and offers placed on NETS by their subscribers (customers) be considered "bids and offers that are in the market" and therefore be provided at no cost to vendors or to a consolidator of market information? Should subscribers be able to designate which of their orders they want treated as "in the market"?*

Upstairs Markets: *Should bids and offers made by dealers to institutions, by institutions to dealers and by institutions through brokers to other institutions be considered to be "bids and offers that are in the market" and therefore made available at no cost to an exchange, vendors or to a consolidator of market information? By what mechanism could this be accomplished?*

Must a policy on NETS information disclosure also deal with "upstairs market" disclosure? How can the Commissions develop a solution that will not significantly undermine the perceived value of the services offered by the respective service providers but which will optimize the quality and quantity of pre-trade information available to enhance price discovery in the Canadian market?

In evaluating the requirements for pre-trade disclosure, respondents should bear in mind that when order information is disclosed in a system it is virtually impossible to limit further disclosure and/or to retain confidentiality concerning such information. If it is of interest, the information quickly becomes known on dealers' and institutions' trading desks.

It appears to be a requirement in the U.S. that the size of bids and offers made by market-makers that are quoting at the best market price in NASDAQ be disclosed where the size of the bids and offers are for 9900 shares or less. It also appears that the SEC is considering extending a similar requirement to non-market-makers.

Is it reasonable in Canada to follow a similar course for all orders (including those placed by non-market-maker subscribers) in a NETS if the orders are made for a longer period than would be considered necessary to invite a potential counter party to enter into negotiation? (For example, see the fourth bullet under #3 below.)

3. General Transparency Requirements

The present disclosure regime of the TSE discloses the full size of all orders that have been entered and identifies on certain terminals (those on desks of member firms), the broker that entered the order. The TSE disclosure regime also publishes the identity of both buying and selling broker on transaction reports.

Is this the appropriate minimum standard? Should all exchanges and NETS in Canada be required to meet this disclosure standard?

Some NETS may provide less disclosure.

- An order is entered in full but it may be divided into “disclosed” and “reserve” portions. When the disclosed portion is filled, it is refreshed from the reserve until the whole order is executed. The disclosed portion of other subscribers' orders at the same price have priority over the reserved amounts. Filling priority is by time of entry of the disclosed portions. The effect of the reserved portion is to dampen the market impact by not having the order fully disclosed, while allowing it to be protected against a trade-through.
- No indication is given by the system as to the identity of the institution or marketmaker behind any order in the order file or on transaction reports.
- Orders can be entered for display to all subscribers or limited to institutions only.
- Unless an order is executed immediately or entered for a specified duration, it becomes inactive after 3 minutes. It remains in the file only as an indication of past interest.

In light of the above and other types of systems such as crossing systems, please

recommend what you regard as an appropriate regime of pre-trade disclosure for traditional exchanges and for NETS. Please consider the following questions in your response:

- a) *If a NETS is required to provide pre-trade disclosure, should such disclosure be:*
 - i) *the same as its customers disclose to each other,*
 - ii) *required to meet the present exchange standard, or,*
 - iii) *required to meet some other standard?*
- b) *Should the present disclosure regime of the exchanges be maintained or should the requirement to report order size and broker identity be relaxed?*

The suggestion has been made that the minimum standard of disclosure of bid and offer information need only extend to the price level that is the best bid or offer level in the respective system. Presumably, vendors will provide an inter-system montage of existing bids and offers that would be similar to what is now provided in the United States by the Consolidated Quotation System -- the National Best Bid and Offer ("NBBO").

C. INTEGRATION OF MARKETS FOR TRADING

Several respondents to the Request for Comments pointed to the selection of models proposed by the TSE Special Committee on Market Fragmentation (the "Committee"). "Model B" envisioned that any electronic trading systems would connect to a Canadian exchange. Any orders or matched trades coming through the system would be subject to the exchange's order display and trade matching protocols. In addition, orders coming from the NETS would be subject to monitoring done by the exchange to manage timely disclosure policy, uncover insider trading and prevent manipulative practices.

Although the TSE has recommended moving forward with Model B immediately, existing NETS and PIAC (on behalf of major institutional investors) have preferred to search for an arrangement that places NETS outside the orbit of the TSE or other existing trading SRO -- the Committee's "Model C". To define a regulatory framework with such characteristics certain trading and regulatory issues must be addressed.

To staff, it appears that there are four issues to address (beyond disclosure of pre- and post-trade information) in order to determine the degree of market integration that the Commissions should order. Where there is more than one market to integrate, the issues would seem to be:

- a) inter-market linkage;
- b) trade-through protection; secondary priority;
- c) secondary priority; and
- d) secondary priority by size of transaction or nature of counter party.

1. Inter-market Linkages

Even though many stocks are interlisted and some actually trade actively on more than one exchange, at the present time, competing markets in Canada are not linked electronically. Present practice requires members handling an order in an interlisted stock to monitor all markets for the best execution opportunity. Most monitoring remains visual, though some electronic monitoring is being introduced.

The potential addition to the Canadian market of one or more NETS invites re-examination of market linking through automation.

Should a bid or offer in one competing market be available for a transaction with participants in other systems? That is, should Exchanges and NETS be electronically linked so that a participant in market A is able to reach into market B to effect an execution against bids or offers in market A?

How should the linkages be created and who should operate the system? For example, through exchanges or a new entity which could be independent of the Commissions or operated by the Commissions.

At least a partial precedent for such linkage has been established in the U.S. where any NASD member can use NASDAQ's Selectnet facility to transact with a bid or offer in an electronic communication network (such as Instinet).

2. Trade-through Protection

Assuming an inter-market linkage for trade execution, consideration should be given to having that linkage provide "trade-through protection". In other words, should price

priority be enforced between markets? Put another way, for a trade to be valid, must it be at a price that is between the inter-market bid-ask spread?

It has been suggested that a bid or offer in a NETS is created by an order that is purely the property of the investor that entered the order. This view holds that the extent to which any information contained in the order is disclosed to others must be determined by the originator of the order. Equally, whether a bid or offer is subject to inter-system execution and on what terms (minimum fill, all or none, any part) should also be determined by the originator.

It is important to note that the choices of the order originator are limited by the variety of facilities made available by the systems that compete to offer services.

Should a NETS (or an Exchange, for that matter) that does not participate in an inter-market linkage and agree to trade-through protection for the bids and offers that have established better prices in other Canadian markets be permitted to operate in Canada? Is that an appropriate minimum standard? Again how should such a linkage be set up and who should operate it?

Should the choice of whether an order participates in inter-market transparency and order linkages be left to investors or should it depend on some objective criteria such as the size of the order?

3. Secondary Priority

If the competing market systems are linked, is it advisable to adopt some form of secondary priority protocol for declared bids and offers in the market at the same price whereby one side of a proposed cross may be “displaced” in whole or part by such prior orders?

Displacement entitlements, based on a secondary priority protocol, are intended to encourage investors to enter limit orders in order to compete to be the priority bidder or offeror. The theoretical work of market-microstructure specialists predicts that such competition will lead to narrow spreads and more robust order books and greater liquidity.

Discussions of displacement and secondary priority raise the issue of “quote matchings” - a practice whereby brokers with a matching buyer and seller can make a “cross” at the same price as the best bid or offer in the market. Even though shares have traded at the same price, the order

posting the best bid or offer does not trade¹.

There are diverse views on this subject. Some hold that the practice of quote matching is unfair to the bidders and offerors who “make the market” and moreover, that it discourages investors and professional market makers from competing aggressively and even from bothering to enter orders.

Others hold that allowing crosses to be executed at previous bid or offer prices is an appropriate reward for the broker that either searched out a counter party or provided the other side of the cross from his own inventory as principal. They note that putting together a large cross frequently involves significant work on the part of a broker. They submit that the block market is unique and that large trades should not be interfered with by relatively small amounts that are typically bid or offered in the market at the best bid or offer price. They see preferred treatment for crosses as providing liquidity and that the expeditious provision of “immediacy”, in the case of a principal trade, is a service that justifies any reduction in the attractiveness of participation in an Order Book by limit order traders.

In addition, those who favour quote matching point out that an exchange or NETS has very limited ability to enforce secondary priority against proposed crosses, when a broker can simply move a proposed cross to a competing market where either quote matching is allowed, there is no pre-existing bid/offer at the same price or non-standard trading prices are offered.

In the context of inter-market linking and integration, is it necessary for the Commissions to take a position on secondary priority and displacement?

4. Secondary Priority Limited by Size of Transaction or Nature of Counter Party

As noted above, certain respondents have submitted that the nature of a large cross may justify different treatment from that accorded to normal order flow. The Toronto Stock Exchange has a by-law change currently out for comment [20 OSCB 6217 (November 21, 1997)]. It suggests that for listed securities agent-principal crosses ought not to be allowed on a quote matching basis if the bid-ask spread is more than one tick and the transaction is a principal trade for 5000 shares or less. The Vancouver Stock Exchange allows quote matching crosses only to the extent of 50% of the proposed cross irrespective of whether a dealer is counter party on one side or the trade is agency on both sides. A respondent has suggested that a cross should be submitted to full displacement by the existing bid/offer up to 10, 000 shares.

¹ This is the present practice in the United States with respect to competing markets. Within their own markets, the New York Stock Exchange and the American Stock Exchange have retained a secondary priority protocol.

Should the size of the cross and or nature of the counter party be a consideration in determining the extent to which a secondary priority protocol be allowed to displace of all or part of a proposed cross?

D. OTHER ISSUES

1. Minimum Price Variation (“tick size”)

The academic literature suggests that tick size must be sufficiently large to make raising or lowering a bid/offer price a significant decision. Otherwise bidders and offerors will find very little reward in entering orders and making the market.

First, if there is no standard tick size (or it is extremely small), any competing trader can better the existing best bid or offer by a tiny amount and, at very little cost, become the priority trader. For persons wishing to have priority an insignificant tick size necessitates continual monitoring and adjustment of their prices. It also means that secondary priority protocols providing for displacement on crosses becomes meaningless, as any price can simply be bettered by a fraction of a cent per share and the cross completed.

In order to encourage participants to enter bids and offers and to protect the notion of secondary priority should the Commissions be willing to set standard tick sizes for a linked Canadian market?

2. Nature of Participants and Transactions in NETS

Should the Commissions have any concern about NETS with a customer base that includes major Canadian and foreign investing institutions as subscribers having as additional customers:

- a) *foreign brokers representing foreign investors;*
- b) *foreign dealers that make markets in Canadian securities;*
- c) *Canadian dealers making markets:*
 - i) *to institutions only;*
 - ii) *to institutions and foreign dealers; or*
 - iii) *to other Canadian dealers.*

Would a NETS be a permissible market through which Canadian brokers and dealers could report crosses? Does it make a difference to your answer whether or

not there is

- a) *inter-market linking;*
- b) *inter-market trade-through protection;*
- c) *inter-market secondary priority?*

Questions may be referred to:

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“See Attached Form”