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Dear Mr. Katz

www.rs.ca

Re: File Number S7-40-04
Submission re Concept Release Concerning Self-Regulation

Market Regulation Services Inc. ("RS") is pleased to respond to the Commission's request for comment on its *Concept Release Concerning Self-Regulation* (Release No. 34-50700).

RS is a national SRO regulating equities trading on marketplaces in Canada. RS believes that its role within the Canadian capital markets presents a regulatory model that ensures that RS can carry out its mandate with independence, fairness and neutrality, while incorporating the benefits of industry input and experience and remaining cost-efficient. RS's development and administration of regulatory policy reflects the front-line expertise of representatives of investors, dealers and marketplaces, and its governance model prevents interest group capture of the rulemaking process. RS therefore believes that it has achieved a unique balance of industry expertise and independence, and suggests the Commission consider a similar model, or components of this model, in reviewing the SRO structure in the U.S.

This submission is organized as follows: Part 1 provides a general overview of RS's creation, jurisdiction, organization and governance. Part 2 uses the list of potential conflicts and other shortcomings within the current U.S. SRO structure (identified in Part IV of the Concept Release) as a framework to analyze how RS's structure addresses those conflicts and shortcomings. Part 3 situates RS within the range of alternative regulatory approaches identified in Part V of the Concept Release. Part 4 concludes.

1. Overview of RS

RS is the independent regulation services provider for Canadian equity markets, including the Toronto Stock Exchange ("TSX"), TSX Venture Exchange ("TSX Venture"),

Bloomberg Tradebook Canada Company (“Bloomberg”), Liquidnet Canada Inc. (“Liquidnet”), and the Canadian Trading and Quotation System (“CNQ”).

RS is recognized as an SRO by the provincial securities commissions of Alberta, British Columbia, Manitoba, Ontario and Quebec (together, the “Recognizing Regulators”), which co-operate in and co-ordinate oversight of its regulatory activities.

RS's mandate is to foster investor confidence and market integrity through the administration, interpretation and enforcement of a common set of market integrity principles (called the “Universal Market Integrity Rules”, or “UMIR”) that apply to all regulated persons¹ in all equities marketplaces² RS regulates. Its market surveillance activities include:

- carrying out real-time and historical trading analysis to identify breaches of UMIR, including trading manipulation, frontrunning and violations of client priority rules;
- conducting investigations and enforcement actions in relation to trading rule violations;
- reviewing news releases of publicly listed companies to ensure timely and accurate disclosure of information; and
- regularly auditing the trade desk procedures of Participants to raise compliance standards and practices.

RS also carries out investigative research for the TSX, TSX Venture and CNQ, providing comprehensive background information on corporations and their officers and directors.

RS is a not-for-profit corporation funded through a transparent, user-pay fee structure. Its staff of 80 in Toronto and Vancouver is made up of industry experts, including former traders, compliance officers, securities lawyers and prosecutors. RS comprises the following principal operational divisions:

- **Market Regulation – Eastern Region** monitors trading activity on the TSX, CNQ, Bloomberg and Liquidnet to ensure compliance with UMIR. Using sophisticated surveillance systems and programs, surveillance experts monitor trading, company news, stock charts, chat room activity and other sources to identify potential trading violations, such as manipulative or deceptive methods of trading, illegal short selling and frontrunning, and identify potential insider trading to be referred to the Recognizing Regulators. The division also conducts trading analysis and investigations to assess potential violations of UMIR, securities legislation and marketplace requirements by market participants on the TSX and CNQ, and undertakes enforcement actions for UMIR violations where necessary.

¹ UMIR applies to two classes of market actors: (1) “Participants”, who are dealers registered in accordance with securities legislation of any province or territory that are members of an exchange, users of a quotation and trade reporting system (“QTRS”) and/or subscribers to an alternative trading system (“ATS”); and (2) “Access Persons”, who are persons other than Participants who are users of a QTRS or subscribers to an ATS. Where the distinction is not relevant, this submission uses the generic term “market participant” to refer to both classes of regulated market actors.

² Under UMIR, a “marketplace” is an exchange (recognized by the applicable securities regulatory authority as such), a QTRS, or an ATS.

The division also monitors issuers' compliance with timely disclosure policies adopted by the TSX and CNQ. Finally, the division is responsible for trade desk compliance for Participants based in eastern Canada.

- **Market Regulation – Western Region** monitors trading activity on TSX Venture to ensure compliance with UMIR, using the same tools in order to identify the same activities as described in the preceding paragraph. The division also conducts trading analysis and investigations to assess potential violations of UMIR, securities legislation and marketplace requirements by market participants on TSX Venture and undertakes enforcement actions for UMIR violations where necessary. The division also monitors compliance with TSX Venture's timely disclosure policies, and is responsible for trade desk compliance for Participants based in western Canada.
- **Market Policy & General Counsel** is responsible for the development and implementation of UMIR and for providing interpretations of, or exemptions from, UMIR with the goal of promoting market integrity. The division also acts as a liaison with the Recognizing Regulators and other SROs. Finally, the division provides legal services to RS in general, including advice, opinions and review, as well as the facilitation of all external legal service providers.

Investigative research for the TSX, TSX Venture and CNQ is managed by RS's Finance and Administration division.

The Creation of RS

Prior to 2002, trading on the TSX was self-regulated by the exchange, which was owned by its members. In 2000, the exchange demutualized and the resulting for-profit corporation was the TSX Group Inc. (the "TSX Group"), which completed its initial public offering and became listed on the TSX in November 2002. TSX Venture was created as the Canadian Venture Exchange ("CDNX") in 1999, comprising the former Vancouver Stock Exchange, Alberta Stock Exchange and Canadian Dealing Network. The TSX Group acquired CDNX in 2001 and renamed it TSX Venture in 2002.

In connection with its demutualization and subsequent initial public offering, the TSX Group divested responsibility for regulating trading on Canadian marketplaces, in part because of the inherent conflict created by the TSX Group being listed on the TSX, and also because it could not appropriately be responsible for regulating trading on QTRSs and ATSSs operating in Canada, which would consider themselves competitors of the TSX.

RS was therefore created in March 2002 as an independent regulation services provider, amalgamating the in-house surveillance, trade desk compliance, investigation and enforcement functions of the TSX and TSX Venture to produce a new single, independent entity to monitor and enforce equity trading rules for Canadian marketplaces.

Jurisdiction of RS

Each exchange or QTRS must set requirements governing the conduct of its members, and either enforce them directly or enter into an agreement with a regulation services provider (“RSP”) that will monitor and enforce compliance with those requirements.

Each ATS must enter into an agreement with an RSP to monitor the trading activities of the ATS and its subscribers, and to enforce the requirements of the RSP relating to the conduct of the ATS and its subscribers.

RS administers and enforces two different types of rules. First, it administers and enforces UMIR, which are “market integrity” rules of universal application that apply to trading on all marketplaces that RS regulates. Second, it administers and enforces marketplace-specific “market quality” rules of the marketplaces that have engaged RS to do so.

RS is presently the only RSP in Canada, and has been retained by all of the current exchanges and ATSS trading listed or quoted equities in Canada.³ RS therefore provides integrated administration, oversight and enforcement of the market integrity and certain market quality rules of all of the equities trading marketplaces operating in Canada. The TSX, TSX Venture and CNQ retain responsibility for their respective listing activities.

The regulatory structure allows for more than one RSP to operate in Canada and in the future it is possible that trading on current or future Canadian marketplaces could be regulated by other RSPs, in addition to RS, although each marketplace would have only one RSP.

Other regulators involved in the regulation of equities trading in Canada include:

- provincial and territorial securities commissions and administrators, which apply provincial and territorial securities laws, regulations and rules; and
- the IDA, which regulates the member activities of investment dealers.⁴

RS is a member of the Intermarket Surveillance Group, comprising 30 exchange regulators around the world, committed to promoting effective market surveillance among international exchanges. RS is also in the final stages of its application to become an Affiliate Member of IOSCO.

³ Currently there are no QTRSs operating in Canada. RS also monitors trading on the Canadian Unlisted Board (“CUB”), a wholly-owned subsidiary of TSX V. CUB operates an internet-based system for the reporting by dealers of trading in unlisted and unquoted (“OTC”) equity securities in Ontario. The Investment Dealers Association of Canada (“IDA”) regulates its members’ trading activity in OTC securities.

⁴ The IDA is the national self-regulatory organization for and representative of Canadian investment dealers. RS regulates investment dealers in terms of their trading activities, whereas the IDA regulates investment dealers in terms of their capital adequacy and business conduct. See also footnote 3 above regarding the trading that the IDA regulates.

Universal Market Integrity Rules

At the time RS was created, RS developed UMIR as a set of equity trading rules designed to ensure fairness and to foster investor confidence. UMIR was established through a consultative process involving industry representatives, legal and compliance officers, the exchanges, trade association representatives, and the provincial and territorial securities commissions and administrators.

UMIR creates the framework for the integrity of trading activity on marketplaces that RS regulates by allowing for the competitive operation of exchanges, QTRSs and ATSS in Canada under a common set of market integrity rules. UMIR regulates various trading practices, including manipulative or deceptive methods of trading, short selling, frontrunning, best execution obligations and order entry, order exposure and client priority obligations.

Since UMIR applies to all trading on the marketplaces that RS regulates, it cannot be circumvented by directing trading activity from one Canadian marketplace to another. Were another RSP to also regulate marketplaces in Canada, it would develop and administer its own market integrity rules, but those rules would have to incorporate the minimum requirements in National Instrument 23-101, titled “Trading Rules” (“NI23-101”), and the RSP would have to enter into a written agreement with all other RSPs, including RS, to coordinate monitoring and enforcement.⁵

UMIR and its companion policies are reviewed and updated by RS in consultation with its Rules Advisory Committee (“RAC”). RAC is made up of industry experts from buy-side and sell-side firms, as well as representatives of the marketplaces that RS regulates and the legal and compliance community. RAC ensures that any proposed rule or policy change adequately addresses market integrity concerns and is in the public interest. RAC also makes certain that changes are practicable and cost efficient from the perspective of marketplaces and market participants. (Appendix “A” lists the current members of RAC.) RAC reviews all amendments to UMIR developed by RS staff and makes recommendations to RS’s Board of Directors. All UMIR amendments must be approved by RS’s Board of Directors before they are submitted to the Recognizing Regulators for review and for a public notice and comment period.

RS is presently engaged in a strategic review of UMIR, intended to ensure that UMIR adequately addresses the risks to market integrity in the most effective and efficient manner, does not impose requirements that are no longer necessary to ensure market integrity, is sufficiently “marketplace neutral” so as not to impede the development of competitive marketplaces, and imposes requirements that differ from prevailing standards in international requirements only where justified by differences in Canadian market structure, industry practices and legal requirements. RS will examine a number of substantive and procedural issues in the strategic review, including whether UMIR should address OTC trading in derivatives, debt instruments and other securities issued by or directly related to issuers with equity securities traded on marketplaces that RS regulates. RS will also examine expanding its ability to foster market integrity in relation

⁵ NI23-101 s. 7.5.

to the activities of persons who have access to a marketplace but who do not presently fall within the definition of Participants or Access Persons.

Ownership of RS

RS is owned as to 50% by the TSX Group, and as to the remaining 50% by the IDA.

Governance of RS

The Board of Directors is responsible for the overall governance and strategic direction of RS. The Board currently comprises 13 members:

- two individuals appointed by the TSX;
- two individuals appointed by the IDA;
- one individual, nominated jointly by the TSX and the IDA, to represent the junior markets;
- one individual, nominated by the Corporate Governance Committee of the Board, to represent ATs;
- six independent members, nominated by the Board on the recommendation of the Corporate Governance Committee; and
- RS's President & CEO.

(Appendix "A" lists the current members of RS's Board of Directors.)

RS has separated the positions of Chair and CEO. In addition, fifty percent of RS's Board (excluding the President & CEO of RS) is made up of independent directors. A director is independent if he or she is not a director, officer, employee or associate of: (a) a marketplace to which RS provides regulation services; (b) a Participant; (c) a shareholder of RS; or (d) an affiliate of any of the foregoing. While RS's independent directors are not affiliated with RS's shareholders or the Participants or marketplaces that RS regulates, they do have significant industry expertise and experience.

Each marketplace regulated by RS is permitted to appoint a non-independent representative to the RS Board of Directors for a term of one year when its market share⁶ reaches or exceeds 10% of the Canadian equity securities market. If, at the end of that term, the marketplace does not meet this market share threshold, the marketplace will not be entitled to representation in the subsequent term. If a non-independent director is added to (or removed from) the Board in this way, an independent director will also be added (or removed) so that there is always an equal number of non-independent directors and independent directors on the Board.

⁶ Market share for this purpose is calculated as a marketplace's share of the Canadian equity securities market calculated on the trading activity in a calendar year, based on 25% of trading value, 25% of trading volume and 50% of the number of trades.

The Corporate Governance Committee of the RS Board is composed of all of the independent directors. The Corporate Governance Committee recommends independent directors, makes recommendations as to the size of the Board and its composition and evaluates the performance of all directors. If the Chair of the Board is an independent director, he or she is a full, voting member of the Corporate Governance Committee. If the Chair of the Board is a non-independent director, he or she is an *ex officio*, non-voting member of the Corporate Governance Committee.

The Finance and Audit Committee consists of at least five directors, the majority of whom must be independent directors, with at least one representative from each of the TSX and the IDA. The members of the Finance and Audit Committee are selected by the Board. The Finance and Audit Committee reviews RS's strategic business planning, fees, and quarterly financial statements, and oversees the audit of RS's annual financial statements.

The Human Resource Committee is composed of four directors, selected by the Board, and the Director of Human Resources (*ex officio*). The Human Resources Committee ensures that high calibre management leads RS, and that there is in place a compensation plan that is competitive, motivating and rewarding to the degree that it will attract, retain and inspire a workforce who in turn will enhance the professionalism and effectiveness of RS.

As is described in more detail in Part 2 below, RS believes that its governance structure guarantees its independence from both its shareholders and the marketplaces it regulates and helps to ensure that equities trading is regulated in a fair, neutral and efficient manner.

Fees and Financial Viability

RS operates on a not-for-profit basis, setting the levels of its fees for administering and enforcing UMIR annually, and charging for marketplace regulation services on a cost-recovery basis. Unlike SROs that also operate marketplaces, RS does not collect revenue from market operations (from sources like tape fees, trading fees or listing fees) that could be used to subsidize its regulatory operations.

RS has two major sources of revenue: (1) fees collected for the administration and enforcement of UMIR, which are billed directly to Participants, and (2) fees charged to individual marketplaces for the additional regulation services that RS provides to those marketplaces. Table 1 below sets out a summary of RS actual revenue for its second- and third-last fiscal years,⁷ and forecast revenue for its last and present fiscal years.

⁷ RS's fiscal year is March 1 to February 28. FY03 covers the period from March 1, 2002 to February 28, 2003; FY06 covers the period from March 1, 2005 to February 28, 2006.

Table 1				
RS Revenue (C\$000)				
	Actual		Forecast	
	FY03	FY04	FY05	FY06
UMIR Fees	21,698	16,612	15,120	15,932
Marketplace Regulation Services	3,973	3,481	3,646	3,685
Other Revenue	235	357	587	344
Total Operating Revenue	26,176	20,450	19,343	19,961

UMIR fees represent approximately 80% of overall RS revenue and consist of two components: a fixed annual fee of \$5,000 charged to each Participant, and a monthly variable fee charged to each Participant based on its percentage share of adjusted⁸ trading volumes. The total UMIR fee is fixed as part of RS's business planning process (approved by RS's Finance and Audit Committee and the full Board of Directors).

Each marketplace is billed directly for additional regulation services, including RS's real-time monitoring of the marketplace's timely disclosure rules as well as investigative research on officers and directors related to listing activities. Marketplace regulation services revenue represents approximately 20% of RS's total revenues. These revenues are determined based on recovery of the full cost of providing these services and are fixed annually under specific regulation services agreements between RS and each of the marketplaces.

Each year, RS benchmarks its fee model against those of other securities regulators, and assesses whether its current fee model adheres to what it has identified as best practices and achieves RS's objectives for the pricing of regulation services, which include transparency, simplicity, neutrality, limited cross-market subsidies, stability and fairness.

Transparency. Transparency allows stakeholders to understand and monitor the true cost of market regulation. In addition, RS believes that market regulation should not be funded by other market-based revenue streams, such as listings fees and sharing of tape revenue, as these revenue streams have no direct relationship to regulation costs.

Under RS's revenue model, Participants and marketplaces are charged directly for their respective regulation services and market regulation is not subsidized by other revenue sources. This transparent approach allows stakeholders to understand the true cost of market regulation and the allocations between the marketplaces and Participants.

Simplicity. Another objective of regulation pricing is to use simple measures of market participation as opposed to complex pricing models that attempt to directly match pricing with underlying costs. Regulation costs are based on a broad range of functions that

⁸ UMIR fee adjustments include a cap of 30,000 shares per trade and a 70% reduction in the fees paid by registered traders on principal trades.

cannot be easily attributed to individual activities or Participants. In other jurisdictions, simple volume or trade-based pricing formulas serve as a proxy for a Participant's benefit from a well-regulated market.

RS's volume-based pricing formula serves as a simple but effective and fair measure of a dealer's participation in the Canadian capital markets.

Neutrality. In order to avoid influencing trading, an important pricing objective is neutrality. Different regulation costs between marketplaces may lead to regulatory arbitrage.

RS has one annual fixed charge paid by Participants in respect of their trading activity on all of the marketplaces that RS regulates, and a single variable pricing rate charged for trading on the marketplaces that RS regulates. This approach ensures neutrality and does not provide an opportunity for regulatory arbitrage.

Limited Cross-Market Subsidies. A single pricing rate for all marketplaces will cause some cross-subsidization unless the cost/pricing ratio is equal among all marketplaces.⁹ In order to completely eliminate cross-subsidization, the pricing formula would need to be based on distinct cost pools for each marketplace and consequently the pricing rate would no longer be neutral (i.e., the same for all marketplaces). Best practice requires a measure of market participation that is neutral but does not result in one market subsidizing another on a large scale.

In order to limit potential cross-subsidization, RS's pricing formula uses volume as the measure of market participation. Junior markets have both higher costs and higher volumes of shares per trade than senior markets, which reduce potential cross-subsidization under this formula.

Although some cross-subsidization between markets can and does occur, in the context of RS's overall regulation fee revenue this subsidy is not large and is insufficient to override the importance of having one rate for all marketplaces. RS monitors this concern to ensure that RS's pricing formula does not lead to a large scale subsidy.

Stability. Implementing a stable revenue stream is another important objective of effective regulation fee pricing. It is preferable to have a pricing formula where monthly revenues do not fluctuate in response to market activity levels or other factors. Regulation pricing that is exposed to fluctuation may require a large reserve to protect against downside volatility. In addition, as Question 21 of the Concept Release suggests, decreasing transaction fees may adversely impact an SRO's ability to fulfill its statutory obligations.

RS's pricing formula charges Participants a fixed monthly amount for UMIR regulation fees. In addition, marketplaces are also charged a fixed amount per month (established

⁹ For example, the cost/pricing ratio would be equal where a junior market is three times more expensive to regulate than the senior market but the junior market also has three times the number of shares per trade compared to the senior market (where volume is the market participation measure). If the junior market was three times more expensive to regulate but had only two times the number of shares per trade, where volume is the market participation measure the senior market would be subsidizing the junior market.

annually in advance) under the terms of the regulation services agreement. This fixed billing approach eliminates revenue exposure to market volatility.

Fairness. Regulation fee pricing should represent a fair measure of market participation and not influence trading activity.

RS believes that volume is a fair and comprehensive measure of market participation that does not influence trading and is not based on other revenue sources. In the interest of fairness, RS applies two adjustments to its volume-based measure for UMIR fees. RS introduced a fee cap of 30,000 shares per trade in order to ensure that large volume trades are not overcharged for regulation. In addition, marketplace members who perform market maker functions receive a 70% fee exemption in order to reflect their regulatory contribution.¹⁰

2. Comparison of “Current SRO System Attributes” and RS Attributes

This Part of RS’s submission uses the list of potential conflicts and other shortcomings within the current U.S. SRO structure (identified in Part IV of the Concept Release) as a framework to analyze how RS’s structure addresses those conflicts and shortcomings. RS believes that its structure and governance provides a useful model for possible restructuring of the current SRO arrangements.

(a) Conflicts with Members and Market Operations

The Concept Release notes that inherent conflicts exist within traditional SROs between their regulatory functions, on the one hand, and the interests of their members and their own (or their affiliates’) market operations, on the other hand.

RS believes that its ownership and governance structure eliminates these conflicts between its regulatory functions, on the one hand, and the commercial interests of the Participants who conduct business on the marketplaces it regulates (who occupy a position similar to the members of a traditional SRO) and the marketplaces themselves, on the other hand.

RS’s operations are separate from the commercial operations of the Participants and marketplaces¹¹ it regulates, ensuring that RS’s regulatory staff are free of inappropriate business pressures that might inhibit effective regulation and discourage vigorous enforcement. This separation also ensures that RS’s staff will not become dependent on Participants or marketplaces for their understanding of market practices, or lose their independent perspective concerning those practices.

¹⁰ This discount applies to members of a marketplace that provide a two-sided market for a particular security on a continuous or reasonably continuous basis, and guarantee the execution of orders for less than the minimum number of units of the security designated by the marketplace.

¹¹ RS has entered into a corporate services agreement with the TSX Group whereby the TSX Group provides information technology and other administrative services to RS. RS has also entered into marketplace regulation services agreements with the TSX and TSX Venture. Both the marketplace regulation services and corporate services agreements have a five-year term beginning on March 1, 2002, with successive renewal terms of one year each. The agreements are linked and each agreement has an option to terminate upon the termination of the other agreement. Each party to these agreements has the option to terminate the agreements. RS is committed to corporate services agreement minimum base cost payments to the TSX Group as follows: in 2005 \$7,152,000, in 2006 \$6,577,000, in 2007, \$6,577,000 and for each renewal year thereafter \$6,577,000.

Because RS serves as an RSP to multiple marketplaces, no one Participant or marketplace is in a position to exert undue influence on RS's regulatory activities, and RS regulatory staff do not come under pressure to over- or under-regulate any marketplace relative to the others in response to competitive pressures affecting those marketplaces.

While Participants and the marketplaces RS regulates are represented on RS's Board of Directors, independent directors who are not associated with Participants or those marketplaces make up half of RS's Board of Directors (excluding RS's President & CEO), and comprise all of the members of the Corporate Governance Committee, and a majority of the members of the Finance and Audit Committee.

RS's regulatory operations are conducted independently of the Board of Directors; the details of specific rulings, investigations and enforcement actions are decided by RS staff without Board review or prior knowledge. These activities are overseen by the Recognizing Regulators and are reviewed as part of the Recognizing Regulators' periodic audits of RS. All settlements of enforcement actions and contested hearings are reviewed and ruled upon by panels made up of individuals, including industry representatives, who are independent of RS staff and RS's Board of Directors.

(b) Conflicts with Issuers

The Concept Release notes that inherent conflicts exist within traditional SROs that operate marketplaces between their regulatory functions and the interests of the issuers listed on such marketplaces.

RS is not subject to conflicts between its regulatory functions and the interests of issuers listed on the marketplaces it regulates because RS is not involved, nor has a financial stake, in the exchange listing and delisting functions identified in the Concept Release. RS administers and enforces the rules of the marketplaces relating to matters like timely disclosure, but does not stand to gain from the enforcement or non-enforcement of those rules. Nor does RS's funding depend on revenues from listing fees and related marketplace charges.

(c) Conflicts with Shareholders

The Concept Release notes that inherent conflicts exist within demutualized, for-profit SROs between their regulatory functions and the interests of their member-shareholders.

RS believes that its ownership and governance structure appropriately addresses any conflicts that could exist between its regulatory functions and the interests of the TSX Group and the IDA.

As noted above, the TSX Group operates the TSX and TSX Venture, and so there are potential conflicts between the TSX Group's commercial interests and RS's regulatory functions. While the TSX Group owns 50% of the shares of RS and is represented on RS's Board of Directors, RS's recognition order requires it to maintain its present Board structure in which independent directors who are not affiliated with the TSX Group make up half of RS's Board of Directors (excluding RS's President & CEO), and comprise all of

the Board's Corporate Governance Committee and the majority of the Board's Finance and Audit Committee.

RS does not believe that the shareholding interest of the IDA gives rise to any conflicts of interest. To the extent that it may be perceived to give rise to conflicts of interest, the composition of RS's Board of Directors and Board committees manages such conflicts, as discussed in the preceding paragraph in relation to the TSX Group.

(d) Inefficiencies of Multiple SROs

The Concept Release identifies several potential sources of inefficiency that may be caused by the existence of multiple SROs regulating a single area of activity. The existence of multiple SROs may give rise to regulatory duplication, regulatory conflicts, the opportunity for "regulatory arbitrage" and unequal funding of SROs.

RS believes that its current role as the sole RSP for Canadian listed and quoted equities marketplaces eliminates most of these sources of inefficiency. RS alone monitors trading on the marketplaces it regulates and enforces the marketplaces' market quality rules. There is therefore no potential or real regulatory duplication, conflict or potential for arbitrage in respect of this area of regulation, and unequal funding is not an issue.

Furthermore, RS's role as the sole current RSP enhances its ability to enter into cooperative arrangements with the IDA, the provincial and territorial securities commissions and administrators and other regulators to minimize regulatory overlap. RS and the IDA are parties to a Memorandum of Understanding and Trade Desk Review Protocol that coordinate RS's regulation of the trading activities of Participants and the IDA's regulation of the business operations and conduct of those same dealers. These agreements allocate primary jurisdiction as between RS and the IDA in respect of any particular conduct, and minimize any duplicative trade desk reviews as between the two regulatory bodies. As noted above, RS's role as the sole current RSP enhances its ability to coordinate its activities with the IDA effectively to avoid unnecessary duplication of resources as well as regulatory gaps.

Unequal funding is a potential issue as between RS and the IDA with respect to their shared area of regulation, but the funding of both organizations is subject to the oversight of the Recognizing Regulators.

Finally, there is some overlap between RS's regulation of the marketplaces it regulates and the jurisdiction of the Recognizing Regulators to regulate capital markets generally in the provinces in which the marketplaces that RS regulates are located. However, the arrangements between the Recognizing Regulators and RS ensure that regulatory effort is not duplicated and that regulatory gaps do not arise. The Recognizing Regulators have entered into a Memorandum of Understanding regarding their oversight of RS, under which the Ontario Securities Commission acts as the principal regulator for the purposes of periodic examinations of RS, reviewing proposed amendments to UMIR, and information filings by RS. The Recognizing Regulators are also parties to a joint rule protocol providing a uniform procedure to coordinate the review and approval of amendments to UMIR.

As noted above, the Canadian regulatory structure allows for more than one RSP to operate in Canada, so in the future, trading on current or future Canadian marketplaces

could be administered and enforced by other RSPs. In this case, it would be possible for concerns to arise relating to regulatory duplication, conflicts and arbitrage, and unequal funding of RSPs.

(e) Intermarket Surveillance

The Concept Release notes that trading activity taking place across multiple markets creates the potential for traders to hide illegal trading activity by dispersing trades across those markets, thereby exploiting monitoring gaps that may be created when different SROs regulate trading on those different markets.

RS believes that its current role as the sole RSP for Canadian listed and quoted equities marketplaces eliminates the potential for intermarket surveillance gaps to appear, for those marketplaces. As new marketplaces begin operations, to the extent that RS is the RSP for those marketplaces, it will continue to provide integrated and coordinated regulation of trading activity without regulatory gaps.

RS does not regulate all trading activity: the Bourse de Montreal regulates its trading in derivatives, and the IDA regulates trading in fixed income markets and its members' trading activity in OTC securities in Canada. RS is engaged in ongoing communication with these other regulators to coordinate efforts to avoid regulatory gaps and to implement cross-market surveillance among these markets. RS believes that its current position as the sole RSP for Canadian equities marketplaces enhances its ability to engage in these cooperative initiatives to coordinate regulation across markets. Nevertheless, some of the issues that RS will be examining as part of the strategic review of UMIR relate to enhancing RS's ability to engage in effective intermarket surveillance and its ability to foster market integrity in relation to the activities of persons who have access to a marketplace but who do not presently fall within the definition of Participants or Access Persons.

RS is an active member of the Intermarket Surveillance Group, the organization that coordinates intermarket surveillance among member SROs and market regulators around the world.

If additional RSPs begin regulating Canadian equity trading in the future, it would be possible for intermarket surveillance gaps to appear. Again, however, a structure in which there are a smaller number of RSPs and other regulators permits greater coordination among those RSPs and other regulators.

(f) Funding

The Concept Release states that regulation must be properly funded and have sufficient resources to be effective, and that there is a risk that traditional SROs may not provide adequate funding to their regulatory operations.

As described above, RS operates on a not-for-profit basis, setting the levels of its fees for administering and enforcing UMIR annually, and charging for marketplace regulation services on a cost-recovery basis. RS is therefore able to ensure that it has adequate resources to effectively fulfill its regulatory function. Furthermore, RS's directors and officers are subject to the corporate law fiduciary duty to act honestly and in good faith

with a view to the best interests of the corporation, which includes ensuring its financial viability.

(g) Effective Liaison

The Concept Release notes that some of the alternative regulatory approaches identified in Part V of the Concept Release would allow for more effective liaisons between the SRO(s) and the SEC, Congress, and international entities on behalf of the industry.

RS believes that its current role as the sole RSP for Canadian listed and quoted equities marketplaces enhances its ability to interact effectively with the Recognizing Regulators, the provincial and Canadian federal governments, other Canadian regulatory bodies, and international regulators, governments and other entities (like the Intermarket Surveillance Group). Indeed, although capital markets are presently regulated by the individual provinces and territories, RS provides regulation on a national basis through its Eastern and Western offices.

3. Alternative Regulatory Approaches and RS

The Concept Release describes the essential characteristics of seven possible enhancements or alternative approaches to address the weaknesses of the SRO system.

To recap the preceding discussion, RS is presently the sole regulator of trading on Canadian listed and quoted equity marketplaces. It administers and enforces the market integrity rules contained in UMIR on all of the marketplaces it regulates. It administers and enforces certain of the market quality rules of the marketplaces it regulates, including those relating to timely disclosure, pursuant to agreements with those marketplaces.

At present, there are no other RSPs that offer the regulation services provided by RS, although marketplaces that are exchanges or QTRSs may elect to revert to self-regulation. Therefore, other RSPs and the exchanges and QTRSs themselves represent a potential source of competition to RS.

Regulation of the capital adequacy and business conduct of the dealers who transact on these marketplaces is performed by the IDA. The Recognizing Regulators (along with the other provincial and territorial securities commissions and administrators) retain jurisdiction over capital markets activity generally, and exercise supervisory jurisdiction over RS's operations.

RS's present position most closely resembles the "Hybrid Model" described in the Concept Release, in which RS performs the role of a single "Market SRO" responsible for regulating trading in individual markets, promulgating market rules, performing market surveillance and enforcing market rules, and the IDA performs the role of the "Single Member SRO."

In addition to the factors addressed out in Part 2 above, the Concept Release identifies a potential drawback of the Hybrid Model: the model creates a "boundary issue" between "member" and "market" rules, which might be difficult to resolve in the case of rules relating to front running or margin requirements. This issue arises in the relationship

between RS and the IDA, but it has not proven difficult to address in practice, as is described in Part 2 above in connection with the Memorandum of Understanding and Trade Desk Review Protocol between RS and the IDA. Again, RS believes that its current role as the sole RSP for Canadian listed and quoted equities marketplaces enhances its ability to interact effectively with other regulators like the IDA.

The Concept Release also argues that the Hybrid Model could reduce regulatory knowledge of business practices by separating the regulatory function from market operations. RS believes that its operations demonstrate that this is not the case and that that the professional experience of its staff, many of whom formerly carried out operational roles as employees of Participants and marketplaces, ensures that effective regulation can be carried out independent of the market and still maintain a strong understanding of both the business and practical realities of trading in the Canadian equity markets. RS's Board of Directors and RAC also provide significant input on major policy issues from the perspective of Participants, marketplaces and investors. Finally, all proposed UMIR amendments must be published for public comment, and RS must take into account the public comments received.

Were another RSP to begin operations, RS and that new RSP would be competitors, and so the model would shift to a version of the "Competing Hybrid" model. The Concept Release identifies the following additional drawbacks associated with the Competing Hybrid model: (1) competing SROs might reduce their fees in an effort to attract and keep new members, which could result in inadequate funding of their regulatory operations; (2) multiple SROs might have conflicting rules; and (3) members may be able to avoid discipline, or otherwise engage in regulatory arbitrage, by switching between SROs.

With respect to funding adequacy, RS and any competing RSP would remain subject to oversight by the Recognizing Regulators. Under the Competing Hybrid model, this oversight could be expanded and enhanced to address concerns relating to funding adequacy. The fact that RS and other RSPs would be single-purpose entities would facilitate such oversight, since there would not be the additional complicating factor of separating the results of market operations from regulatory activities.

The rules developed and administered by competing RSPs would remain subject to rules promulgated by the provincial and territorial securities commissions and regulators. NI23-101 has been adopted by the relevant securities commissions, and contains substantive provisions relating to manipulation and fraud, best execution, regulatory trading halts, monitoring and enforcement of trading, audit trail requirements, and related matters¹² that apply to trading on all Canadian marketplaces. NI23-101 would therefore provide a regulatory floor with respect to the trading rules on any individual marketplace.

Finally, the coordinated oversight of competing RSPs by the Recognizing Regulators would make it relatively straightforward to ensure that enforcement proceedings could be continued or transferred in the situation where a regulated person moved from the jurisdiction of one RSP to another.

¹² A person or company is exempt from the provisions of NI23-101 relating to manipulation and fraud, best execution and regulatory trading halts if the person or company complies with similar requirements established by, *inter alia*, an RSP.

In summary, RS believes that its governance structure, together with the coordinated oversight of RS and any other RSPs by the Recognizing Regulators, would address the concerns raised in the Concept Paper relating to the Hybrid and Competing Hybrid Models. Nevertheless, RS believes that the Hybrid structure allows for relatively more efficient and effective regulation of Canadian equities trading marketplaces.

4. Conclusion

In conclusion, RS believes that its governance arrangements ensure that it will carry out its regulatory responsibilities with independence, fairness and neutrality, while incorporating the benefits of industry input and experience and remaining cost-efficient. RS therefore believes that it has achieved a unique balance of industry expertise and independence, and suggests the Commission consider a similar model, or components of this model, in reviewing the SRO structure in the U.S.

Yours truly,

A handwritten signature in black ink that reads "Tom Atkinson". The signature is written in a cursive style with a large initial "T".

Tom Atkinson
President & CEO

Appendix A
RS Board of Directors and Rules Advisory Committee

Board of Directors

<u>Name</u>	<u>Status</u>
William W. Moriarty – Chair Managing Director RBC Capital Markets	IDA Representative
Tom Atkinson	RS President & CEO
Luc Bertrand President & CEO Bourse de Montreal	Independent Director
Ian Brown Senior Managing Director Raymond James Ltd.	Junior Markets Representative
Bruce S. Garland Vice President Bloomberg Tradebook Canada LLC	ATS Representative
Eric Kirzner Professor Rotman School of Business, University of Toronto	Independent Director
Jean Martel Senior Partner Lavery, de Billy	TSX Representative
Richard Nesbitt CEO TSX Group Inc.	TSX Representative
Joseph J. Oliver President & CEO IDA	IDA Representative
Ermanno Pascutto Lawyer	Independent Director
Kathryn Perry Financial Consultant	Independent Director
Gerry Rocchi Director of Americas iShares and Intermediary Investor Ventures Barclays Global Investors Canada Limited	Independent Director
Grant Vingoe Partner Arnold & Porter LLP	Independent Director

Rules Advisory Committee

<u>Name</u>	<u>Status</u>
M. Cecilia Williams, Chair Managing Director / Head of Compliance Scotia Capital / Scotia Wealth Management	Legal / Compliance Representative
Jean-Guy Brunelle, Vice-Chair Managing Director, Proprietary Trading National Bank Financial	Participant Representative
Timothy Baikie General Counsel and Corporate Secretary Canadian Trading and Quotation System	CNQ Representative
James Bolen Equity Trader – Public Market Investments Canada Pension Plan Investment Board	Institutional Investor / Subscriber Representative
James Ehrensperger Managing Director, Institutional Equity Trading BMO Nesbitt Burns	Participant Representative
Bruce S. Garland Chief Operating Officer Bloomberg Tradebook Canada Company	Bloomberg Tradebook Representative
Andrew Jappy Head, International Trading Canaccord Capital	Participant Representative
David Lang Managing Director, Global Institutional Compliance RBC Dominion Securities Inc.	Legal / Compliance Representative
Jean Martel Lavery, de Billy Barristers and Solicitors	Legal / Compliance Representative Member of RS Board
Rik Parkhill Senior Vice President Trading, TSX Markets TSX Group Inc.	TSX Representative
Phil Schmitt Summerhill Holdings Inc.	Institutional Investor / Subscriber Representative
Ray Tucker Managing Director, Institutional Equities TD Securities Inc.	Participant Representative

Name

John Washburn
Director, TSX Market Services, TSX
Markets
TSX Group Inc.

William W. Moriarty (ex-officio)
Managing Director
RBC Dominion Securities Inc.

Tom Atkinson (ex-officio)

Status

TSX Venture Representative

Chair of RS Board

RS President & CEO