

December 4, 2002

No. 2002-001

Suggested Routing: Administration & Finance, Trading, Legal & Compliance

REQUEST FOR COMMENTS

PROPOSAL TO EXEMPT TRADES PURSUANT TO MARKET MAKER OBLIGATIONS FROM THE PAYMENT OF REGULATION FEES

Summary

On November 19, 2002, the Finance and Audit Committee of the Board of Directors of Market Regulation Services Inc. ("RS") approved the release for public comment a proposal to exempt trades made on a marketplace pursuant to Market Maker Obligations from the payment of the Regulation Fee charged by RS (the "Proposal"). The Toronto Stock Exchange ("TSX") has requested that RS circulate the Proposal for comment.

Market Making Obligations Under UMIR

The Universal Market Integrity Rules ("UMIR") define "Market Maker Obligations" as obligations imposed by the rules of a recognized exchange (an "Exchange") or a recognized quotation and trade reporting system (a "QTRS") on a member or user or a person employed by a member or user to guarantee:

- a two-sided market for a particular security on a continuous or reasonably continuous basis; and
- the execution of orders for the purchase or sale of a particular security which are less than a minimum number of units of the security as designated by the marketplace.

In order to provide market makers with the ability to fulfil their obligations, UMIR exempts trades made by a market maker in fulfilment of their Market Maker Obligations from the restrictions on making a short sale below the last sale price. UMIR also exempts market maker trades that are automatically generated by the trading system of a marketplace from the rules on client priority.

In accordance with National Instrument 21-101 (the "Marketplace Operation Instrument"), an Exchange or QTRS may have rules regarding Market Maker Obligations. Each Exchange and QTRS may define those obligations, subject to regulatory approval, to best suit the pattern of trading on that marketplace. However, the Marketplace Operation Instrument precludes an alternative trading system ("ATS") from having a market making structure. Nonetheless, the Marketplace Operation Instrument requires an ATS to be connected to each Exchange or QTRS that is the principal market for a security traded on the ATS.

The Proposal

The TSX has provided the attached memorandum that outlines the background and the reasons for the Proposal to:

- exempt trades made pursuant to Market Maker Obligations from the payment of the Regulation Fee;
- recover the cost of providing the exemption by increasing in the Regulation Fee to other Participants; and
- make the exemption effective as of January 1, 2003.

In connection with the Proposal, comments are requested specifically on:

- whether an exemption from the payment of the Regulation Fee should be granted to trades made by Market Makers in their stocks of responsibility; and
- if an exemption is granted, the appropriate mechanism for RS to recovering the cost of the exemption.

Comments should be in writing and delivered within 30 days of the date of this notice to:

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Current Regulation Fee Model

Presently, RS assesses a Regulation Fee on all trades executed on the TSX and TSX Venture Exchange ("TSX VE"). The Regulation Fee is assessed against each Participant based on their percentage of overall adjusted volume of trading on marketplaces regulated by RS. If a trade involves more than 30,000 units of a security, the excess volume is not included in either the Participant's volume or the overall volume of RS-regulated marketplaces. Each month each Participant will be assessed a percentage of the RS monthly budget that is equal to their percentage of the adjusted trade volume. Presently, trades pursuant to Market Maker Obligations are included in volume for the purposes of calculating the Regulation Fee. Both the buy and the sell side of a transaction are included in the calculation of overall adjusted volume.

If RS provides services to a marketplace other than the monitoring of orders and trades for compliance with UMIR, RS charges the marketplace a separate fee based on the estimate of

time and cost in providing such services. Periodically, RS will review these additional charges to ensure that they are fair and reasonable and cover the actual cost of providing the services.

Impact of the Proposal

All trades made in stocks of assigned responsibility on the TSX by RTs and Specialists and on the TSX VE by Odd Lot Dealers would be exempt from the payment of the Regulation Fee under the Proposal.

Based on recent trading volumes for market makers as provided by the TSX and TSX VE, it is estimated that market makers pay Regulation Fees of approximately \$850,000 to \$925,000 annually in respect of trades in their stocks of responsibility. If the exemption requested in the Proposal is granted and the amount of the exemption is recovered from other Participants, the Regulation Fee for a Participant that is not a Specialist or Odd Lot Dealer and with no RTs would increase approximately 4.2%.

Process for Approval of Changes to the Regulation Fee Model

RS is recognized as a self-regulatory organization by the Alberta Securities Commission, British Columbia Securities Commission, Manitoba Securities Commission, Ontario Securities Commission and the Commission des valeurs mobilières du Québec (the “Recognizing Regulators”). The Recognition Orders require RS to have a fair, transparent and appropriate process for setting fees. These fees must be allocated on an equitable basis among marketplaces and marketplace participants and must balance the need of RS to satisfy its responsibilities without creating barriers to access.

At this time, RS has not adopted a position with respect to the Proposal. RS will take into account comments received in response to this Request for Comments in making a recommendation to the Board of Directors of RS. If the Board of Directors adopts a change to the Regulation Fee Model to provide a full or partial exemption for trades made by Market Makers, the change may require the approval of the Recognizing Regulators prior to implementation. Depending upon the nature of any change adopted by the Board of Directors, the Recognizing Regulators may require that the change be published and subject to a public comment period as part of their consideration of the change.

Recommendation of the Rules Advisory Committee

On October 30, 2002, the Rules Advisory Committee of RS (“RAC”) reviewed the Proposal and recommended its adoption by the Board of Directors. RAC is an advisory committee to the Board of Directors of RS and is comprised of representatives of: each of the marketplaces for which RS acts as a regulation service provider; Participants; institutional investors; and the legal and compliance community.

ALEXANDER DASCHKO
VICE PRESIDENT, OPERATIONS,
GENERAL COUNSEL AND SECRETARY

December 4, 2002



PROPOSAL TO EXEMPT TRADES PURSUANT TO MARKET MAKER OBLIGATIONS FROM PAYMENT OF REGULATION FEE

Overview

The TSX is proposing that trades on a marketplace pursuant to Market Maker Obligations be exempted from the payment of regulation fees charged by Regulation Services ("RS"). This proposed exemption is based on strong demand from the TSX's participating organizations in response to the three discussion papers concerning market making reform released for public comment by TSX Markets this year.

Market makers receive a TSX trading fee exemption, because the TSX recognizes the unique role that Registered Traders (RTs) play in enhancing the efficiency and effectiveness of price discovery, augmenting liquidity, filling liquidity "gaps", supporting the order flow of the small retail investor, and providing a frontline role in monitoring situations in the marketplace that simplifies the work of regulating the marketplace. Prior to the demutualization of the TSX in 2000, the cost of regulation was recovered as part of the trading fee. Therefore, RTs were exempted from RS fees and other market participants absorbed the full cost of regulation. When a separate regulation fee was introduced after demutualization, the exemption for RTs was not addressed.

As a result of extensive consultation with market participants and analysis, the TSX has concluded that the current RS fee levy on market makers trading in their stocks of responsibility is an impediment to liquidity and should be removed in the interest of the Canadian capital markets. Further the cost of providing such an exemption to market makers on any marketplace should be borne by other market participants generally.

At present, it is estimated that the increased cost in terms of RS fees to other market participants of the implementation of an RS fee exemption for RTs trading in their stocks of responsibility would be up to 4.2%. It is worth noting that RS has modified its fee schedule twice this year, which involved cost transfers of much greater magnitude among market participants.

Proposed Regulation Fee Model

The TSX is proposing that RS will continue to assess a regulation fee as described in the RS covering letter (attached) under the section entitled "Current Regulation Fee Model", with the exception of the trades undertaken by a Participant pursuant to their market making obligations. All RT trades in their stocks of responsibility for the purpose of Market Making (i.e. trades that are not Client, Non-Client, NX or Pro) will be removed from the overall volume of all RS regulated marketplaces. The newly adjusted volume,

which constitutes total market volume adjusted for the 30,000 shares per trade cap less Market Making trades, will be used to assess each Participant's monthly percentage share of the RS monthly budget.

The Role of the RT as a Benefit to the Marketplace

Price Discovery & Liquidity

The registered trader as a market maker contributes to the price discovery and liquidity in the trading of a security by maintaining a continuous two-sided market within a certain spread goal. As well, for interlisted securities, they are charged with maintaining a market for the security that is competitive with other markets where the security trades. Market makers are also involved in managing the opening.

TSX recognizes that these activities are a benefit to all market participants, including potential ATSS. By enhancing price discovery and liquidity on the primary Canadian market, the RT helps lower the market impact cost of trading for all market participants, regardless of where they trade.

Retail-sized Order Flow Support

The RT also levels the playing field for small investors through maintaining the size of the Minimum Guaranteed Fill (MGF) requirements and an automatic and immediate 'one-price' execution of MGF eligible orders. Coupled, with the aforementioned maintenance of a two-sided market, particularly on less liquid securities, the RT ensures that retail investors have an ability to compete for order flow in the marketplace.

The RT also guarantees fills for odd lot and mixed lot orders at the current board lot quotation. This activity, borne as a cost to the RT, is a clear economic benefit to retail investors. Without RTs, they would be forced to pay a competitively priced liquidity premium or discount when buying or selling odd or mixed lots in the market.

RTs in their market maker obligations have a disproportionate share of trades (16.64% from Jan. 1, 2002 to May 31, 2002) in a stock versus the volume or value (4% and 4.05% respectively) traded due to the nature of their duties (retail sized order flow and filling odd lots).

Without the elimination of RS fees on RT trades, there will be fewer and fewer firms willing to provide RT services, which will have a negative impact on the health of the marketplace, specifically on retail-sized investors. The cost disincentive to RTs is amplified in deteriorating markets, particularly at the point in time they are necessary to fill in liquidity 'gaps'.

Regulation

Market makers provide services to the marketplace in a quasi-regulatory role through the assumption of a number of additional responsibilities.

- Reporting forthwith any unusual situation, rumor, activity, price change or transaction
- Identifying anomalies in orders in the book
- Assisting in investigations
- Augmenting liquidity and dampening volatility

RTs ensure that the market functions in a more predictable, less volatile manner, which in turn makes the job of regulating the market far less arduous, and implicitly lowers the RS cost of regulation.

Alternate Trading Systems

While an ATS is prohibited by current regulations from having a market making regime, the Marketplace Operation Instrument requires that each ATS maintain a connection to the principal market of any security traded on that ATS and that the ATS be given access to the orders equivalent to the access that the market provides to its own participants. In this way, orders entered on an ATS in a particular security directly or indirectly benefit from the performance of market maker obligations. Specifically an ATS benefits through higher levels of liquidity and market depth through its connection to the principal market. If the contribution of market makers is of general benefit to the market, a marketplace with a market maker regime and those without should be left competitively neutral by any proposal.

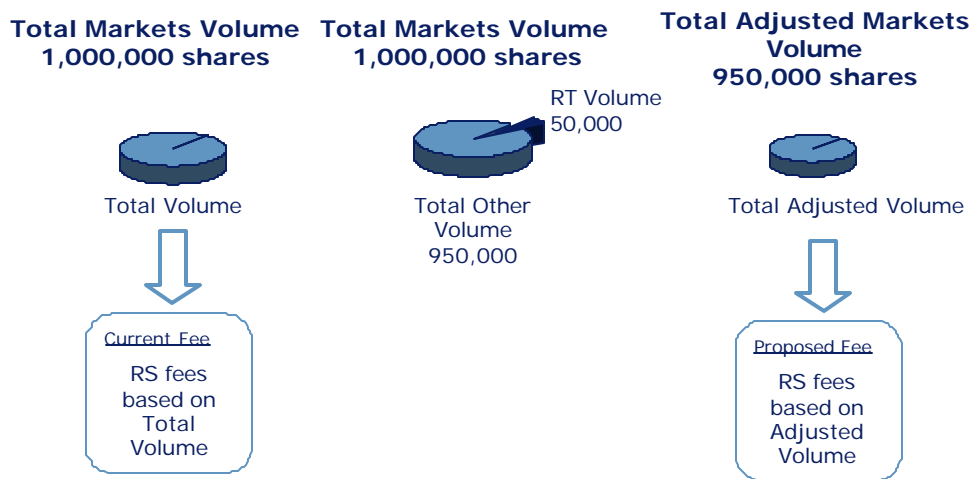
Who Should Bear the Cost?

It is the position of the TSX that all beneficiaries of Market Making share proportionately in the cost of supporting the Market Maker system. As a “public good”, where all participants can be expected to benefit from Market Makers, any other cost-sharing model would unfairly subsidize other aspects of the system. Under the TSX-initiated proposal:

- Participating Organizations will shift the cost of RS fees on RT trades on to their non-RT trades. Specifically, current regulation services fees on

the trades that provide liquidity, price discovery and orderly markets will be absorbed by other trades that receive a benefit directly or indirectly from the services outlined above. The increase estimated in regulation fees per participating organization will be up to 4.2%, depending on the degree to which the participating organization currently employs market makers.

- RS as a regulator remains revenue neutral through this proposal.
- TSX already pays for market making through foregone trading fees.
- Any potential Client, Non-client or Inventory trades on an ATS will be competitively equal to similar TSX trades in terms of regulation fees.



The diagram above graphically displays the RS fee exemption for RTs and how participating organization regulation fees will be levied on an adjusted volume base. That is RT volumes in stocks of responsibility will be deducted from total marketplace volumes and regulation fees will be levied per participating organization based on the percentage of volume traded on the adjusted volume base. At first glance, a potential counter argument to this methodology may be that an ATS without market makers is paying higher regulation fees than the TSX with market makers. This argument is fallacious. The participating organization bears the cost of regulation fees and each participating organization will have the same non-RT RS fee formula on each marketplace, leaving no participant at a regulatory cost advantage over any other participant.

In other words, any failure to adjust total markets volume by RT trades, will give a participant on an ATS a free ride on the activities of market makers on the principal market for a security. Further, any marketplace participants trading on an ATS will be receiving an indirect subsidy funded indirectly by those participants choosing to support the price discovery process in the primary market.

The distinction of who bears the cost, participant or market, is subtle yet critically important in this analysis. The key being, under the TSX proposal, ATS trades for regulation fee purposes are priced equal to TSX non-RT trades.

As a result, the TSX believes that the acceptance of this proposal should ultimately be determined by participating organizations. A broad cross section of market participants (including those without market makers who would assume a greater proportion of the shifted regulation fee burden) have already expressed a willingness to bear this cost (see Appendix for a list of Market Making firms), as they perceive the value gained by the Market Maker system to be of greater benefit to them.

Conclusion/Recommendation

To summarize, the TSX proposal is as follows: to exempt payment of the regulation fee to trades made pursuant to market maker obligations, to transfer the cost of such an exemption to other participants, and to make the exemption effective January 1, 2003. This proposal is a valid response to industry demand, and has already received the support of the Rules Advisory Committee of RS. It also recognizes the RT's support of price discovery, liquidity, and retail order flow; the implicit partnership between Regulation Services and Market Makers; and the potential benefits that ATSs gain from market making activity through their connections to the principal market.

All trades made in stocks of responsibility on the TSX by RTs and Specialists and on the TSX VE by Odd lot dealers would be exempt from the payment of the regulation fee under this proposal.

The TSX believes that it is in the interest of the Canadian capital markets that the market maker exemption from payment of RS fees be granted as soon as possible.

**Appendix – Breakdown of RTs and Assignments
as at end of September 30, 2002**

BROKER NAME	# RTs	TOTAL Assignments (end - Q3)
National Bank Financial Corp.	41	282
W. D. Latimer Co. Ltd.	29	269
Yorkton Securities Inc.	24	148
Independent Trading Group	21	115
Canaccord Capital Corp.	27	106
Raymond James Ltd.	13	105
Jones, Gable & Company Ltd.		03
Dundee Securities Corp.	18	89
Hampton Securities Ltd.	10	74
RBC Dominion Securities	15	74
Nesbitt Burns Inc.	9	35
Desjardins	4	31
Research Capital Corp.	3	25
Peters & Co. Ltd.	2	21
Griffiths McBurney & Partners	3	17
BYRON SECURITIES INC.	4	16
Jitney Group	2	15
ScotiaMcleod Inc.*	1	10
Brawley Cathers Limited	1	4
Pope & Company	1	3
OCTAGON CAPITAL CANADA CORP	1	1
MAPLE (Bonds)	1	0
HSBC Securities Canada Inc.	0	0
CAT TOTALS	238	1543
*exited the business post-Sept. 30		