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**VIA EMAIL**

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Dear Sirs/Mesdames.

**Re: IIROC Notice 20-0202 (the “Notice”) – Proposed Amendments Respecting the Trading of Derivatives on a Marketplace**

The Montreal Exchange (“**MX**” or “**we**”) welcomes the opportunity to respond to the invitation by the Investment Industry Regulatory Organization of Canada (“**IIROC**”) to comment on proposed amendments (the “**Proposed Amendments**”) to the Universal Market Integrity Rules (“**UMIR**”) that would regulate the trading of listed derivatives on a marketplace for which IIROC acts as the regulation services provider (“**RSP**”). Capitalized terms used in this letter and not otherwise defined have the meaning given to them in the Proposed Amendments.

**Summary**

While withholding comment on the substance of the Proposed Amendments, MX is of the view that it is not IIROC’s responsibility under the current regulatory framework to draft the Proposed Amendments. Below is a high-level summary of the points developed further in the comments that follow:

1. Under the law, rulemaking is a function reserved to marketplaces and not RSPs. We are unaware of any derivatives marketplace that has retained or proposed to retain IIROC as RSP and are therefore concerned by the fact that the Proposed Amendments have been drafted in a vacuum, with no grounding in the specific regulatory issues that arise in the context of a specific marketplace and its listed products.
2. While, in the equities world, UMIR has evolved into a set of rules independently maintained by IIROC, both the context in which UMIR was developed and the unique nature of derivatives trading reinforce the proposition that marketplaces, rather than RSPs, are best-suited to develop rules of the nature of the Proposed Amendments.
3. For an RSP to take the initiative of drafting market integrity rules for a derivatives marketplace deviates from international best practices.

4. The abstract nature of the Proposed Amendments makes it unclear on what basis IIROC has developed the impact assessment set forth at Appendix E to the Proposed Amendments.
5. If and when a new derivatives exchange is recognized in Canada it will be necessary for MX, IIROC and the new exchange to consider how to address their obligation to coordinate monitoring and enforcement set forth at section 7.5 of *Regulation 23-101 respecting Trading Rules* (“**23-101**”).

## **MX Regulatory Division**

MX has been recognized as a self-regulatory organization since 2000.<sup>1</sup> In 2005, we retained the services of the Investment Dealers Association (now IIROC) as RSP to oversee dealer conduct, but have always retained and directly exercised our authority to oversee our markets and trading thereon via our regulatory division (“**MXR**”). MXR is today composed of 28 full-time personnel that monitor on average 50,000 daily trades having a nominal value of over \$144 billion, made by 63 participants both Canadian (51%) and foreign (49%).

MXR operates within the framework of MX’s rulebook (the “**Rulebook**”), which defines the parameters within which trading activities on MX take place, prohibits abusive practices (such as frontrunning and insider trading) that would impede the proper and legal functioning of a marketplace and establishes MXR’s authority and procedures for enforcement activities. The contents of the Rulebook are constantly being refined in accordance with regulatory and industry feedback, as well as best practices as determined by our experience and international benchmarks. Indeed, we note that the drafters of the Proposed Amendments drew on the contents of the Rulebook.

## **Responsibility for Marketplace Rules in Canada**

Under Canadian securities laws, recognized exchanges alone hold the authority to establish rules governing their members’ conduct. Section 7.1 of 23-101 provides as follows:

### **7.1. Requirements for a Recognized Exchange**

(1) A recognized exchange must set requirements governing the conduct of its members, including requirements that the members will conduct trading activities in compliance with this Regulation.

(2) A recognized exchange must monitor the conduct of its members and enforce the requirements set under subsection (1), either

(a) directly, or

(b) indirectly through a regulation services provider.

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<sup>1</sup> [Decision 2000-C-0729](#) of the Quebec Securities Commission. *Bulletin hebdomadaire de la commission des valeurs mobilières du Québec* (2000-12-08, vol. XXXI, no. 49). MX’s current recognition order was issued in 2012; see [Decision 2012-PDF-0075](#) of the *Autorité des marchés financiers. Bulletin de l’Autorité des marchés financiers* (2012-05-03, vol. 9, n° 18).

(3) If a recognized exchange has entered into a written agreement under section 7.2, the recognized exchange must adopt requirements, as determined necessary by the regulation services provider, that govern the recognized exchange and the conduct of the exchange's members, and that enable the regulation services provider to effectively monitor trading on the exchange and across marketplaces.

While a recognized exchange may retain the services of an RSP to monitor and enforce its rules, the exchange itself retains ultimate responsibility for those functions.<sup>2</sup> The RSP is thus a subcontractor acting as a surveillance and enforcement agency on the exchange's behalf. This framework requires exchanges to develop and maintain the expertise needed to design rules that are suitable to their operations and marketplace, while also making them responsible for how those rules are applied.

#### *Historical Background for UMIR*

UMIR is "a common set of equity trading rules designed to ensure fairness and maintain investor confidence" over which IIROC has responsibility for "development, amendment, interpretation, administration and enforcement."<sup>3</sup> Originally, however, UMIR was a joint initiative of the Toronto Stock Exchange and the Canadian Venture Exchange, in response to proposals of the Canadian Securities Administrators to regulate the operation of exchanges and as described in the Ontario Securities Commission bulletin that contained the first draft of UMIR:

On July 28, 2000, the Canadian Securities Administrators (the "CSA") republished for comment two proposed national instruments and related documents (the "ATS Proposal") as part of their initiative to create a framework for the competitive operation of traditional exchanges and Alternative Trading Systems ("ATs"). The ATS Proposal sought to foster the trading of securities in a competitive environment in a fair and transparent manner. The national instruments were identified as proposed National Instrument 21-101 - *Marketplace Operation* (the "Marketplace Operation Instrument") and proposed National Instrument 23-101 - *Trading Rules* (the "CSA Trading Rules").

The Canadian Venture Exchange ("CDNX") and TSE Regulation Services ("RS") initiated a project to develop an alternative to replace the CSA Trading Rules. The Toronto Stock Exchange (the "TSE") and CDNX reviewed their respective rules and policies to determine if the CSA Trading Rules were appropriate for the structure of their markets. A secondary goal of this review was to determine the extent to which differences in the rules and policies of the exchanges could be

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<sup>2</sup> Subparagraph 7.1(3) requires the exchange to adopt certain requirements, as determined by the RSP. The Policy Statement to Regulation 23-101 and the drafting history of the provision indicate that this provision was added to clarify an existing requirement that the recognized exchange must cooperate with its RSP so as to enable the latter to properly carry out its functions.

<sup>3</sup> [Information Circular Regarding the Special Meeting of IDA Member firms to consider the proposed combination of the Association and Market Regulation Services Inc. in a new self regulatory organization](#), November 15, 2007, p. 1.

removed and trading rules harmonized. This initiative resulted in the formulation of "Universal Market Integrity Rules" ("UMIR") designed to promote a fair and orderly market and to apply on a general basis to securities listed on the TSE and CDNX or traded on another marketplace, including an ATS.<sup>4</sup>

While IIROC was ultimately given responsibility over UMIR, those rules were a joint and voluntary initiative of stock exchanges responding to concerns that external actors would impose on them their own set of requirements. Following UMIR's adoption, those exchanges adopted it as part of their own rules. If, today, IIROC monitors and enforces UMIR in its capacity as RSP for Canada's recognized equities exchanges, it is because those exchanges have retained IIROC as RSP and adopted UMIR into their own rulebook.

For IIROC, as RSP, to take the initiative of drafting rules to govern the integrity of hypothetical derivatives marketplaces is the diametric opposite of the process described above. IIROC's role as an RSP subcontracted by marketplaces does not and, in our view, should not include the development of new rules on its own initiative.

### **Derivatives Trading and Regulation**

In the Notice, IIROC states, "An important consideration in developing these Proposed Amendments was that all rule amendments pursued should, where possible and appropriate, result in the consistent regulation of trading in listed securities and trading in listed derivatives." While the derivatives and equities markets may share some general features, they have fundamental differences that require very different approaches to regulation and make the goal of harmonization between listed securities and derivatives unachievable.

Equities markets trade securities that are created and listed by issuers, generally common or subordinate voting shares with identical characteristics defined by corporate statutes: one vote per share, entitlement to a dividend if and when declared by the board, and the right to a residual claim in case of liquidation. Such securities are therefore highly fungible or even identical, in the case of those that trade on multiple marketplaces. Those features enable issuers to easily cross-list their securities or to transfer a listing from one marketplace to another, for example in the case of a graduation from the TSX Venture Exchange to the Toronto Stock Exchange. They also make it feasible to regulate market integrity and trading across marketplaces: different marketplaces generally face similar issues and can therefore generally adopt similar rules.

Derivatives markets are fundamentally different; the securities traded on MX are creations of MX itself. MX defines their characteristics and is the sole marketplace on which participants can trade them.<sup>5</sup> Another marketplace would be poorly placed to list MX's bespoke derivatives for trading, and new products routinely give rise to novel regulatory issues that MXR must analyze when determining how to monitor trading in them.

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<sup>4</sup> Ontario Securities Commission [bulletin](#), April 20, 2001, p. 2559. Emphasis added.

<sup>5</sup> [Article 6.2](#) of the MX Rulebook: "Subject to the exceptions set out in Article 6.12, 6.204 and Article 6.200, all Transactions in Listed Products made by Approved Participants, an affiliated corporation or a Person must take place on the Bourse during a trading session thereof."

For these reasons, the “one-size-fits-all” approach taken to the equities markets would be a poor fit for the derivatives markets. In their case, the need for each recognized exchange to develop its own set of rules - that it can then monitor and enforce itself, or subcontract those functions to an RSP - is not just a regulatory requirement, but also a reflection of commercial reality and practical necessity.

## **US Experience**

Given MXR’s status within MX, the Proposed Amendments could apply only in a situation where multiple derivatives exchanges have been recognized in Canada. Given the hypothetical nature of this scenario, it is instructive to review the situation in the United States, which as a significantly larger market has a long history of multiple derivatives exchanges and other trading platforms.

IIROC’s counterpart in the United States, Financial Industry Regulatory Authority, Inc. (“**FINRA**”), has adopted a rulebook that establishes market trading rules applicable to all FINRA members. Certain transactions, such as member transactions that take place on alternative trading systems (“**ATs**”), which have no rules of their own, are subject solely to FINRA’s trading rules based on FINRA’s jurisdiction over the broker-dealer ATs.

However, each U.S. exchange continues to maintain and enforce its own rules for trades made on exchanges. As in Canada, American exchanges draft and adopt their own rules governing trading on their markets. And therefore member transactions that take place on exchanges continue to be subject to the relevant exchange rules. The exchanges are responsible for monitoring and enforcing those rules, and many have elected to perform certain oversight and enforcement functions internally. The exchanges may also subcontract those functions to an RSP. Those that have elected to retain FINRA as RSP have charged it with overseeing and enforcing their own rules, drafted by the exchange itself. The exchanges opine on whether their rules have been violated and determine what sanctions are appropriate. FINRA acts only as a service provider and each exchange is deemed best able to decide how its rules should be enforced.

Indeed, the U.S. exchanges have recently increased their independent enforcement of their own rules, relying less on FINRA as RSP. The New York Stock Exchange (NYSE) began conducting its own surveillance and enforcement for activity on its own markets in January 2016; last year, the Securities and Exchange Commission approved Nasdaq’s similar proposal to assume operational responsibility for certain investigation and enforcement functions previously performed by FINRA. The SEC approved these rule changes based on the exchanges’ representations that they would facilitate the early detection and prompt disposition of potentially violative conduct, and timely action when appropriate. The U.S. transition to the Consolidated Audit Trail (CAT), a central repository of detailed audit trail information about securities transactions, also illustrates the U.S. trend toward more, not less, exchange self-regulation. Today the exchanges largely rely on FINRA to conduct cross-market surveillance. When CAT is fully implemented, the exchanges will be required by SEC rule to use CAT data to regulate their markets. On August 21, 2020 the SEC released a proposal specifying how each exchange could analyze CAT data. Some U.S. exchanges may choose to conduct cross-market

surveillance and independently pursue any resulting enforcement actions, without using FINRA as an RSP in any way.

The American experience, and its continued shift towards more independent regulation by exchanges, is consistent with the proposition that it is proper from the legal, commercial and practical points of view that recognized exchanges should bear sole responsibility for drafting, maintaining, overseeing and enforcing their rules.

### **Impact Assessment**

Appendix E to the Proposed Amendments sets forth “the major policy elements of the Proposed Amendments, along with a description of the intended policy benefits of each element and an assessment of its impact on investors, Participants, Marketplaces and IIROC itself.” Overall, their impact is judged to be “generally net positive” for investors and IIROC, “neutral to positive” for Marketplaces and a mix of “minor negative” and “neutral to positive” for Participants.

We salute IIROC’s effort to assess the impact of the Proposed Amendments on various stakeholders, as it can help clarify their benefits and burdens. At the same time, it is unclear on what those assessments are based. Each category of amendments is described as constituting a net positive, negative or neutral. However, those labels are relative terms that have meaning only in comparison to some alternative and the Proposed Amendments have no reference point relative to which their impact can be described as positive or negative.

By way of example, IIROC states that the extension of prohibitions on abusive trading and frontrunning to derivatives would constitute a “net positive” for investors, as they “are intended to enhance market integrity and designed to detect and deter manipulative and deceptive activities as well as crossasset frontrunning.” MX fully agrees that abusive trading and frontrunning compromise market integrity, but these prohibitions can only constitute a positive if they are adopted in a context where derivatives transactions are taking place with no such rule. MX is currently Canada’s only derivatives marketplace and the Proposed Amendments would not apply to derivatives traded on MX (nor, as noted at Appendix E, do they purport to do so).<sup>6</sup>

As a result, we submit that any determination as to whether the Proposed Amendments constitute a net positive is premature. Assuming that they are ultimately integrated into UMIR, only if and when a derivatives marketplace has retained IIROC as RSP and adopted the Proposed Amendments can they be compared to that marketplace’s existing rules and their relative impact properly assessed.

### **Additional Marketplaces**

If and when a new derivatives exchange is recognized in Canada and depending on the nature of the instruments that are to be traded on this new exchange, it will be necessary for MX, IIROC and the new exchange to discuss how to give effect to their obligations under section 7.5 of 23-101, under which they are required to enter into a written agreement with all other regulation services providers, recognized exchanges, and recognized quotation and trade

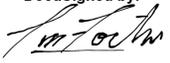
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<sup>6</sup> MX’s Rulebook prohibits a broad range of abusive trading practices, including frontrunning at [Article 7.6](#).

reporting systems to coordinate monitoring and enforcement of the requirements set under Part 7 and 8 of 23-101.

### **Conclusion**

We thank IIROC for providing us with the opportunity to comment on the Proposed Amendments and would be pleased to discuss our comments with you.

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Luc Fortin

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