

IN THE MATTER OF: THE COMMODITY FUTURES ACT

- and -

**IN THE MATTER OF: Application of WINNIPEG COMMODITY
EXCHANGE INC. for continued registration as an Exchange pursuant to
Section 15 of The Commodity Futures Act**

**REASONS FOR DECISION
OF
THE MANITOBA SECURITIES COMMISSION**

The Manitoba Securities Commission received an application from the Winnipeg Commodity Exchange Inc. (WCE or the exchange) dated September 15, 2004 seeking regulatory approval for its planned conversion from an open outcry to an electronic trading platform. The application also requested non-disapproval from the commission with respect to changes to WCE rules required to implement the conversion.

The Commodity Futures Act provides the statutory framework for the oversight of the exchange by the commission and the review of the application. Section 15 of the Act requires a commodity futures exchange to be registered with the commission and states:

Requirement to register as exchange

15(1) No person or company shall carry on business as a commodity futures exchange in Manitoba unless it is registered as a commodity futures exchange under this Part.

Registration

15(2) Upon application by or on behalf of a person or company wishing to carry on business in Manitoba as a commodity futures exchange, the commission shall grant registration to the person or company where it is satisfied that to do so would not be prejudicial to the public interest, taking into account whether

(a) the clearing arrangements and the financial condition of the exchange, its clearing house and members provide reasonable assurance that all obligations arising out of contracts entered into on the exchange will be met;

(b) the internal regulations of the exchange that govern its members and members of its clearing house are in the public interest and are actively enforced;

(c) floor trading practices are fair and effectively supervised;

(d) adequate measures are taken to prevent manipulation and excessive speculation;

(e) adequate provision is made to record and publish details of trading, including volume and open interest; and

(f) the exchange is in compliance with this Act, the regulations and the rules and is able to continue to be in compliance.

The legal test to be satisfied is in effect a public interest test, whether registration of the exchange would be prejudicial to the public interest taking into account the criteria set out in the Act. It is the view of the commission that the criteria set out in the Act are not intended to be exhaustive, but are intended to assist in defining whether an applicant has demonstrated its registration is not prejudicial to the public interest.

The application contains a significant number of amendments to the rules of the exchange. While implementation of these rule amendments would effectively implement electronic trading of exchange contracts, it is the view of the commission that the significant changes in the operation of the exchange resulting from a conversion from open outcry to electronic trading requires the commission to review the new operations of the exchange to determine if the exchange continues to satisfy the criteria required for registration as an exchange under the Act.

Comment Period

Given the attention paid by industry and interested third parties to the proposal to convert to electronic trading, the commission felt it would be beneficial to provide an opportunity to interested parties to comment on the application.

The public comment period ended on October 22, 2004. Twenty two comment letters were received. The members of the commission have reviewed all of these comment letters and thank all interested parties who took the time to comment. The comment letters and the application are available for viewing on the commission's website.

Portions of the application that contain propriety information about the trading systems and their architecture have not been placed on the public record. Section 68(3) of the Act permits the commission to hold in confidence these materials. However, it is clear from the comments received there has been sufficient materials placed on the public record for parties to be in a position to comment on the application.

Comment letters

All of the comment letters expressed support for the continued operation of the exchange. Clearly the exchange performs a significant and vital function bridging both the needs of the agricultural community and the needs of the investment community.

The comment letters also reflected the importance of liquid markets to both the viability of the exchange and the needs of parties that directly or indirectly rely on the exchange. Increased

liquidity improves the efficiency of the market and provides the exchange with the financial resources it requires to carry on its business.

Finally, related to the liquidity issue is the need for price discovery through the operation of transparent markets. There is significant reliance in Canada and around the world on the price discovery function provided by the exchange.

While there were many comment letters in support of the conversion to electronic trading, there were some comment letters that took the position that a conversion to electronic trading would not be in the interest of the exchange, parties that rely on the exchange or the markets generally.

Business Environment

There have been significant changes and trends in the business environment facing the exchange that are relevant to the review of the application.

Consolidation in the agricultural industry has resulted in a reduced number of market participants. A decrease in the number of market participants creates a challenge for the exchange to the extent there needs to be a healthy level of competition to establish liquidity in the market.

The globalization of the agricultural industry and increased global trade in agricultural products has required the exchange to expand its business development activity beyond the Canadian market. While many farmers and others in the Canadian agricultural industry rely on the price discovery function of the exchange, many of these parties do not directly trade on the exchange. In order for the exchange to maintain a dominant position as a price discovery mechanism for its markets it must be in a position to develop business both within and outside of Canada.

The business of operating a futures exchange has also seen significant changes in recent years. What were in the past primarily regionally based businesses are rapidly becoming international in scope through amalgamations, consolidations and alliances. One of the steps taken by the WCE to deal with these competitive forces was to convert its business structure to a for profit model in 2002. The conversion to a for profit model in part reflected the need of the exchange to be in a position to adapt its business activities to meet changes in how its business is conducted.

These market forces were some of the factors that lead the WCE board of directors to decide to pursue the conversion of the open outcry trading platform to an electronic trading platform.

It is important to note that whether or not there was a conversion to electronic trading the exchange would still have been faced with significant costs to upgrade its existing trading systems. While the proposal to convert to electronic trading results in costs to participants on the exchange, these participants would have still faced additional costs if the exchange did not move to an electronic system and was required to upgrade existing trading systems.

Open Outcry vs Electronic trading

Both open outcry and electronic trading platforms have operated successfully in various markets.

Regulatory objectives requiring a fair and efficient market can be achieved through either an open outcry or electronic trading platform.

The commission determined through the granting of the registration orders to the WCE in both 2000 and 2002 that the open outcry trading process presently in use by the exchange meets the requirements for registration of an exchange under the Act. However, the granting of each of the registration orders does not prevent the exchange from pursuing changes that can potentially improve its operations while maintaining the regulatory objectives of fair and efficient markets.

The proposal to convert to electronic trading has the advantage of relying on an existing trading platform known as e-cbot® powered by LIFFE CONNECT®. In reviewing the sufficiency of the trading system (including its functionality, compliance and reporting functions) the commission has the benefit of the fact that the system is operational, has been reviewed by, and continues to be under the oversight of the Commodity Futures Trading Commission in the United States.

The commission has also concluded the proposed trading system complies with the standards for electronic exchanges set out in the October 2000 Report of the Technical Committee of the International Organization of Securities Commissions (IOSCO) Principles for the Oversight of Screen-Based trading Systems for Derivative Products published in October 2000.

The commission is satisfied the changes to the rules of the exchange that have been filed as part of the application are consistent with the requirements for the fair and efficient operation of an electronic trading system.

The commission is satisfied the electronic trading platform and rules governing trading on the exchange establish compliance with each of the criteria set out in section 15(2) of the Act.

Impact on markets

There is no question the conversion from an open outcry to an electronic trading system requires significant changes to the method by which participants conduct trading of exchange products. The final matter requiring consideration by the commission is whether the impact of these changes will create such a disruption in the market as to require additional terms and conditions on the registration of the exchange.

The role of the commission as regulator is not to second guess business decisions made by the exchange, its board of directors and shareholders unless it can be shown that implementing the business decision would be prejudicial to the public interest.

While all participants are required to expend time and effort to convert to electronic trading, many larger firms already conduct electronic trading on other markets and can adapt these systems to accommodate electronic trading of WCE products. It appears the greatest impact of the conversion will be felt by smaller traders who have had little or no exposure to electronic markets.

The WCE has made a significant commitment to assist Locals to convert to electronic trading at little or no cost. It is possible some of these participants will not take the opportunity to convert

to electronic trading and choose not to continue to conduct business on the exchange. It is also possible the exchange may (it is by no means certain) see a drop in trading volumes for a period of time after the conversion. Whether or not the trading volumes will be replaced by other participants is unknown. The view of the exchange is that the conversion to electronic trading using an established system will place it in the best possible position to take advantage of new business opportunities.

While recognizing the possibility of reduced volumes of trading in the short term, the commission does not view this risk as imposing any greater risk upon the market than would be in place if the conversion were not permitted and the exchange was required to continue operation of an open outcry trading system.

The commission also considered the possibility of conditions on registration that would require the exchange to operate both an open outcry and electronic trading system for a trial period. In addition to the increased cost and complexity of operating a dual trading system, the commission is not convinced there is sufficient liquidity in the market to facilitate two trading systems operating simultaneously. The commission is also concerned that imposing a requirement to operate dual systems would create uncertainty in the market as participants could not be certain which of the two systems would prevail. This period of uncertainty could lead to a loss of confidence in the exchange and its markets.

Decision on application

The commission has determined the criteria for registration as an exchange under the Act has been satisfied by the WCE and that registration should continue. The commission would also confirm that WCE Holdings Inc. should continue to be a party to the commission order given the corporate relationship between the exchange and WCE Holdings Inc.

The commission would also confirm that the terms and conditions of order No. 3784 dated June 11, 2001 continue to apply. Commission staff is directed to review the existing registration order with the WCE to confirm the terms and conditions set out remain valid and to advise the members if changes are required.

November 15, 2004

"D.G. Murray"
D.G. Murray
Chair