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September 19, 2005

BY E-MAIL

Members of the Canadian Securities Administrators
c/o John Stevenson, Secretary
Ontario Securities Commission
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- and –

Anne-Marie Beaudoin
Directrice du secrétariat
Autorité des marchés financiers
Tour de la Bourse
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Montréal, Québec H4Z 1G3

Dear Sirs/Mesdames:

Re: Request for Comment – CSA Discussion Paper 23-403
Market Structure Developments and Trade-Through Obligations

1. Introduction and Overview

Market Regulation Services Inc. ("RS") is pleased to have the opportunity to provide its initial comments on the Canadian Securities Administrators' Discussion Paper 23-403 – *Market Structure Developments and Trade-Through Obligations* (the "Discussion Paper") as part of its continuing participation in the Canadian debate on market structure and trade-through obligations.

RS supports the need for trade-through obligations that benefit investors on Canadian marketplaces. Regulation can and should address the market failures that trading through reflects and the harm that trading through causes. The Universal Market Integrity Rules ("UMIR") are therefore built around the premise that a fair and orderly market is one which respects the notion that the best-priced orders should trade first as investors' orders compete for execution. RS therefore supports the continued existence of trade-through obligations.

RS's position is based on its belief that the trade-through obligation is properly understood as an obligation that is separate from the duty of best execution and that is owed by market participants to the market and other market participants. RS believes that any other conception of the nature of the trade-through obligation has significant implications for the level of fragmentation within the Canadian equity markets that should be carefully considered.

RS also believes that market regulation should, above all other goals, protect investors from the effects of market failures. Other benefits of allowing market forces to operate, such as promoting innovation and competition, should be pursued only to the extent that they are compatible with investor protection, particularly the protection of retail investors' interests. RS believes that two other regulatory objectives should support the use of regulation to protect investors in a manner that does not impede competition, innovation or otherwise interfere with market forces: ensuring that regulatory requirements are marketplace-neutral, and ensuring that regulatory requirements create a level playing field among market participants.

RS believes that an approach that imposes trade-through obligations on marketplaces has merit and should be studied, but observes that such an approach requires a rule that defines the obligations of Participants and Access Persons[1] trading on markets outside of Canada.

Finally, RS believes that the debate should, at this stage, focus on the fundamental principles underlying trade-through obligations and market structure; the Discussion Paper raises a large number of subsidiary issues that threaten to obscure these principles. RS believes that there are key issues that require further research, analysis and discussion in the context of the current debate, including the impact of trade-through obligations on innovation and competition and the relevance of U.S. Regulation NMS ("Reg NMS") and its associated empirical studies. RS is performing research that will address these and other issues, and will set out its research findings in its second comment in October.

This is RS's initial comment on the Discussion Paper. RS wishes to participate in the public forum to be held on October 14, 2005, and will provide a second and final comment to the CSA by October 20 to provide the final results of its research and to provide comments on the subsidiary questions raised in the Discussion Paper. RS's final comment will also provide an overview of the comments that RS receives on Market Integrity Notice 2005-016 – *Request for Comments – Interim Provisions Respecting Trade-Through Obligations* (May 12, 2005).[2]

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[1] As defined in UMIR, "Participants" are dealers that are members of an exchange, users of a quotation and trade reporting system, or subscribers to an alternative trading system ("ATS"); "Access Persons" are non-dealer subscribers to an ATS. Other capitalized terms not otherwise defined in this comment have the meaning attributed to them in UMIR.

[2] (2005) 28 OSCB 5064 ("MIN 2005-016").

2. About RS

RS is the independent regulation services provider for Canadian equity markets, including the Toronto Stock Exchange ("TSX"), TSX Venture Exchange, Bloomberg Tradebook Canada Company, Liquidnet Canada Inc., Markets Securities Inc. and the Canadian Trading and Quotation System.

RS's mandate is to foster investor confidence and market integrity through the administration, interpretation and enforcement of UMIR, which applies to all regulated persons in all equities marketplaces RS regulates.

RS is recognized as a self-regulatory organization by the provincial securities commissions of Alberta, British Columbia, Manitoba, Ontario and Quebec (the "Recognizing Regulators").

3. RS Participation in the Policy Process

RS has played a central role in the trade-through debate to date. As the SRO responsible for administering and enforcing market integrity rules for all Canadian listed equity trading marketplaces, including any trade-through obligation that emerges from the current process, RS looks forward to continuing to work closely with the CSA as it considers its response to the input received on the Discussion Paper.

RS believes that it is important that the public record be complete and accurate respecting recent events relating to trade-through obligations. Appendix "A" provides background on RS's participation in the policy process, and RS's response to certain aspects of the Discussion Paper's analysis of RS's proposed interim provisions respecting trade-through obligations.

4. Relationship Between Trade-Through Obligations and Best Execution

RS believes that it is critical that the debate on trade-through obligations proceeds under a clear and common understanding of the current trade-through rules.

The Discussion Paper overstates the relationship between the duty of best execution and trade-through obligations. **Trade-through obligations and best execution are two distinct and separate concepts, and the debate on trade-through obligations is confused by this linkage**. Specifically, RS disagrees with the statements in the Discussion Paper that trade-through obligations "were developed as part of the codification of the fiduciary duty of a dealer to its client" and "were not developed to facilitate a separate obligation on all participants to the market and to orders already in the book."[3]

In fact, prior to the consolidation of the Canadian equity trading markets in 2000, each of the exchanges had displacement requirements that prevented members from trading through better-priced orders on the exchange. These displacement requirements further provided that exchange members had to honour better bids or offers for interlisted

[3] Discussion Paper ((2005) 28 OSCB 6333) at 6335.

securities on other Canadian exchanges. This was a separate obligation from the duty of best execution.

For example, TSE Board of Governors Rule 90-08 provided:

> Members are aware of their fiduciary duty to their client to obtain the best available price. The Exchange also recognizes that members have a duty to the market (and, therefore, a duty to other members) to honour better bids or offers on the Exchange. In order to preserve the integrity of the Exchange's markets, the Board of Governors has rules that a member shall not trade through a better bid or offer by making a transaction on another exchange or market at a price inferior to the posted price on the TSE. … This rule applies even if the client consents to the trade on the other exchange at the inferior price. … Members are also reminded of their responsibility not to trade through better bids or offers on other Canadian exchanges.

Vancouver Stock Exchange Rule C.3.41, effective October 30, 1997, provided:

> Members shall not trade-through better priced markets on Canadian Exchanges, unless the better priced markets are filled before or at the same time as the trade in the market upon which the trade is made.

The 1997 report of the TSE Special Committee on market fragmentation provides a consistent account of the exchanges' trade-through obligations prior to the consolidation of the exchanges, explaining that trade-through obligations preserve the fairness of the market.[4]

At the time that UMIR was drafted, National Instrument 21-101 - *Marketplace Operation* (the "Marketplace Operation Instrument") contemplated that, prior to the creation of a market integrator, each marketplace trading a security would be under an obligation to maintain an electronic connection to every other marketplace trading the same security. With later amendments to the Marketplace Operation Instrument that became effective in January 2004, the CSA eliminated the requirement for each marketplace to maintain an electronic connection.[5] This change removed the requirement for a mechanism that would have allowed orders to "migrate" to other marketplaces with better-priced orders. The UMIR amendments proposed by RS in MIN 2005-016 (the "Trade-Through Amendments") were designed to address the gap which was created with the elimination of the mandatory electronic connection between marketplaces.

UMIR and the former marketplace rules have always provided that a Participant's displacement obligation applies even if the client consents to a trade at an inferior price.[6]

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[4] *TSE Special Committee Report – Market Fragmentation: Responding to the Challenge* (1997) at 59.
[5] The Industry Committee on Data Consolidation and Market Integration issued a report to the CSA in March 2003 ((2003) 26 OSCB 4385). In its report, the Committee stated that marketplace data connections were required to ensure market integrity, but recommended against a centralized data consolidator that was not market-driven. The Committee recommended that regulators specify data specifications and standards to be used in the market-driven data consolidation. The Committee's report also specifically noted the need to further consider how best to enforce trade-through obligations using the consolidated data feed. The Committee's recommended data consolidation model, therefore, was not inconsistent with the possibility of marketplace-level trade-through rules.
[6] UMIR Policy 5.2, Part 2.

These policies clearly indicate that the displacement obligation is separate from the duty of best execution that is owed to the client.

In addition, the scope of the trade-through obligation is logically inconsistent with the scope of the duty of best execution. Displacement obligations in Canada have always extended to <u>all</u> better-priced orders.[7] If the trade-through obligation was simply an aspect of best execution, the displacement obligation would only logically need to extend to the <u>best</u>-priced orders with an aggregate volume equal to the size of the client order (i.e., the Participant should be required only to fill the client order at the best possible prices).

Limiting trade-through obligations only to Participants handling client orders, which would be natural consequence of treating them as an aspect of best execution, also has the undesirable effect of creating an unlevel playing field as between Participants and Access Persons. It would create a disincentive for an investor to trade by means of placing a client order with a Participant – in which case the trade-through obligation would apply to the Participant's handling of the order – compared to trading by means of placing an order directly on a marketplace – in which case the trade-through obligation would not apply. RS submits that there is no policy rationale to depart from rules that are marketplace-neutral in this manner.

The unequal treatment of Participants and Access Persons under this best execution concept of trade-through obligations is also unfair to Participants, who are subject to a regulatory requirement in connection with their trading as principal that does not apply to Access Persons trading on their own behalf.

To the extent that there is a relationship between trade-through obligations and a Participant's duty of best execution, it is that best execution is facilitated by the price discovery mechanism that is in turn supported by effective trade-through obligations. Trade-through obligations also provide a "backstop" to the duty of best execution to the extent that clients believe that dealers are prohibited from executing their orders at inferior prices.

All of the foregoing is consistent with the trade-through obligation representing a duty to the market that should apply to all market participants. The following section of this comment outlines the public policy rationale for trade-through obligations on this basis.

5. Rationale for the Current Rule

The underlying rationale for the duty to the market was analyzed in detail in MIN 2005-016[8] and can readily be understood from first principles of market failures and the role of regulation. While certain investors may have *bona fide* reasons to want to execute a trade at an inferior price, including greater perceived certainty or speed of execution at that price on one marketplace relative to another, **there are strong theoretical**

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[7] The Trade-Through Amendments provide a cap on the displacement obligation: the undisclosed portion of "iceberg" orders on the TSX would not be protected by trade-through obligations if the trade takes place within certain price parameters. This serves to promote the principle of protecting orders that add to visible liquidity for all trades, while making the displacement obligation more manageable for most trades.

[8] MIN 2005-016 at 5067-70.

arguments that the practice of trading through impairs market quality for all investors, and that trade-through obligations are an appropriate regulatory response.

Regulatory intervention in a market may be justified when that market displays one or more types of market failure, such as monopoly, information asymmetry and/or externalities.[9] Where these defects negatively affect the market and its participants, and the market cannot self-correct them, regulation is an appropriate and justified response where the benefits of regulatory intervention outweigh its costs. Selecting among alternative forms of regulatory intervention can also be done on a cost-benefit basis.

In the case of trade-throughs, two types of market failure exist. The first is information asymmetry. Returning to the relationship between trade-through obligations and best execution, properly understood, dealers and their clients have unequal information about the dealer's handling of the client's order. A dealer may profitably trade a client order at an inferior price, but the client would incur significant costs if he or she monitored every aspect of the dealer's performance in connection with each trade, including the relationship between market prices and the price at which the client's order was filled. As noted above, trade-through obligations therefore provide a "backstop" to the duty of best execution to the extent that clients believe that dealers are prohibited from executing their orders at inferior prices, and provide an overall benefit to the extent that clients do not incur such monitoring costs.

The second market failure is the negative externalities imposed on certain investors by trading through. This is a separate concern from the information asymmetry between a dealer and its client, because it arises whether trading takes place through a dealer or directly on an ATS.

Trading through imposes negative externalities on investors who place limit orders. For example, an investor may place a limit order on a marketplace to buy a security with a limit price of $20, meaning the investor is willing to pay up to $20 for the security. If another investor sells the same security for $19 on another marketplace or organized regulated market, that investor has traded through the $20 limit order, receiving $1 less than it would have had it traded with the limit order.

As many commentators have noted, investors who place limit orders provide a "free option" to other market participants, who may elect to trade with displayed limit orders at any time to take the liquidity that those limit orders offer. Investors who trade through limit orders also "free ride" on the price discovery that limit orders provide. The investor who placed the limit order, on the other hand, loses that opportunity to trade when the order is traded through and so may gain nothing from placing the order.

Limit orders are a necessary component of efficient, liquid markets because they play an essential role in the price discovery process. Limit orders provide liquidity and depth to a market, thereby improving market quality for all investors, including

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[9] An externality exists where the costs and/or benefits of a decision are not confined to the party making the decision. Externalities may be negative (as in the adverse effect of pollution on surrounding communities if the owners of a factory decide not to invest in emissions-control equipment) or positive (as in the positive effects on society of an individual's decision to invest in his or her education).

investors who place market orders. The impact of limit orders on market quality is highlighted by the fact that retail and institutional investors, as well as dealers trading as principal, place limit orders. Institutional investors and dealers trading large positions use limit orders as part of a number of trading strategies. Therefore, the negative impact of trade-throughs on limit orders will affect the behaviour of not just retail investors, but also the institutional investors and dealers who provide a significant portion of the liquidity on marketplaces.

As a result of these negative externalities created by trade-throughs, however, investors who find that their limit orders are being regularly traded through and not filled may be less likely to provide this liquidity to other investors because they will not derive any benefit from doing so. **This effect may be particularly pronounced given that the status quo has been that trade-throughs do not occur on Canadian marketplaces**; investors who take it as a given that their limit orders are protected may react strongly if that status quo is abruptly changed by the introduction of multiple marketplaces.

As fewer limit orders are placed by investors, market quality declines for all investors. In the absence of a large number of competitive limit orders, investors placing market orders and investors negotiating large block trades will be less confident that the market price represents an accurate benchmark for their orders or trades. Furthermore, trade-through obligations best protect those aggressive limit orders that narrow the spread for a particular security, encouraging investors to place such orders and benefiting all investors through tighter spreads.

Preventing trade-throughs therefore enhances market quality for all investors by encouraging greater use of limit orders. Canada's smaller markets, which face constant competition from U.S. markets, can ill-afford to lose this important source of liquidity, particularly at a time when the U.S. is moving to enhance the protection of limit orders under Reg NMS. Efficient and effective price discovery is particularly important in Canadian markets which are comparatively less deep and liquid than U.S. markets.

There are other potential negative externalities. Trade-throughs affect investors who place market orders by creating a perception of unfairness to those investors if their orders are filled at prices inferior to better available bid or ask prices.

RS believes that the combined adverse effect of all of these potential impacts of trading through is significant enough to merit regulatory intervention. RS believes that the cost and complexity of trade-through obligations, properly designed, will be outweighed by their aggregate benefits. **RS therefore believes that the order of an investor which has been exposed on a marketplace and has contributed to the functioning of the price discovery mechanism should not be intentionally bypassed by other investors prepared to trade at an inferior price, and that all market participants owe a duty to the markets to prevent this from occurring**. RS therefore endorses the arguments canvassed in the Discussion Paper that trade-through obligations promote investor confidence and liquidity in the markets as a whole, and that trade-through obligations are owed by all market participants to other investors and to the market in general.

6. Regulatory Objectives

RS believes that the proper role of regulators in defining and pursuing objectives for the appropriate market structure and requirements for Canada is more limited than those set out in the Discussion Paper,[10] yet also more significant because it addresses more fundamental concerns.

RS does not believe that regulators should seek to design market structure or drive trading decisions through regulation. For example, the third objective identified in the Discussion Paper is promoting displayed depth.[11] RS believes that market regulation should not be dictating any particular level or form of transparency. Instead, pre- and post-trade transparency is a determinant of market quality that should be within the control of individual marketplaces and subject to market forces of supply and demand in marketplace design, as opposed to a centrally-determined regulatory requirement.[12]

RS believes that the regulation of market structure should, above all other goals, protect investors from the negative externalities of trade-throughs. Other benefits of allowing market forces to operate, such as promoting innovation and competition, should be pursued, but only to the extent that they are compatible with investor protection. That is, the protection of all investors' interests, but particularly fairness to investors who are not in a position to protect themselves, should be the overriding concern rather than simply another consideration to be weighed in regulating market structure.

RS believes that two other regulatory objectives support the use of regulation to protect investors in a manner that does not impede competition, innovation or otherwise interfere with market forces.

First, **regulatory requirements should be marketplace-neutral**: RS believes that the existence of different regulatory requirements among marketplaces, or regulatory requirements that have a differential impact on marketplaces, create the undesirable potential to influence investor behaviour in unintended ways and to encourage regulatory arbitrage. In the context of the trade-through debate, RS believes that trade-through obligations, and the investor protection they provide, should apply equally to all marketplaces.

Second, **regulatory requirements should create a level playing field among market participants**: RS believes that regulatory requirements should apply equally to all market participants, where the activities of those market participants give rise to similar market integrity risks. In the context of the trade-through debate, RS believes that

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[10] The Discussion Paper states (at 6335): "The CSA have identified the following objectives as the factors that should be considered in identifying the appropriate structure and requirements for Canada: (1) balancing regulation and competition among all types of marketplaces; (2) recognizing and supporting the role of retail participation in the market; (3) promoting greater order interaction and displayed depth; and (4) encouraging innovation."

[11] Discussion Paper at 6335.

[12] This is not to say, however, that regulators should not take into account the differing levels of transparency among marketplaces in determining what market integrity requirements should apply to those marketplaces and how.

Participants and Access Persons should be subject to the same trade-through obligations when trading the same securities. For example, **one class of investors – institutional investors who have access to both retail and "wholesale" markets for securities – should not be permitted to decide, on a trade-by-trade basis, whether to trade *with* or to trade *through* public limit orders**.

RS is also concerned that the current comment process and the public forum to be held on October 14, 2005 will not provide an opportunity for the CSA to receive meaningful input from retail investors on an issue that affects them directly. RS therefore believes that the CSA should assign investor protection, and the interests of retail investors who may not have a voice in this debate, the highest priority, and should ensure that it has consulted with retail investors as part of its deliberations.

7. Marketplace-Level Solution

As noted above, **RS believes that an approach that imposes trade-through obligations at the marketplace level has merit and should be studied. RS specifically invited comment on this issue in MIN 2005-016**[13] and will provide an overview of the comments it receives in its second comment in October.

The Discussion Paper identifies two potential disadvantages of the marketplace-level solution: (i) the risk that requiring a marketplace to route orders to another marketplace would affect innovation and the ability of marketplaces to design creative models of execution or limit their access to particular participants; and (ii) the potential costs to marketplaces of establishing the systems necessary to enforce trade-through protection.[14]

RS agrees that these are the principal considerations associated with the marketplace-level solution, except that RS believes that the marketplace-level solution will also have an impact on competition among marketplaces that should be taken into account. The research that RS is conducting is designed to address both of these issues, as described below.

However, the concerns that arise in connection with a participant-level solution relating to market participants' differing proficiency and capability to comply with trade-through obligations can be addressed within that solution. Marketplaces themselves and third-party vendors may develop interconnections and tools that would assist participants to comply with their trade-through obligations. For example, a marketplace may impose restrictions on trading activity that prevent trade-through of other marketplaces to which it has created an electronic connection. Third party vendors may provide smart order routers (technology that is currently and widely used in the U.S.) or other tools that will automate the process of complying with trade-through obligations for market participants. Conversely, marketplaces may shift the burden of compliance to market participants under a marketplace-level solution. All of these possibilities should be taken into account in comparing the two alternatives.

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[13] MIN 2005-016 at 5076.
[14] Discussion Paper at 6343.

Finally, **while RS believes that the marketplace-level solution recently adopted in the U.S. under Reg NMS is a useful model, it also believes that a supplementary market participant-level obligation regarding trading outside Canada is necessary**. That is, market participants should not be permitted to trade through better-priced orders on a Canadian marketplace by directing their trading activity to markets outside Canada, but should remain subject to their obligation to displace those better-priced orders on Canadian marketplaces. A trade-through obligation that was implemented at the level of Canadian marketplaces would not affect such trading, since there would be no mandatory connection between Canadian marketplaces and foreign markets.

RS believes that such an obligation is necessary in Canada to protect better-priced orders on Canadian marketplaces given the significance of trading in interlisted securities on Canadian marketplaces. For example, trading in U.S.-interlisted securities represented approximately 60% of total trading by value and approximately 38% of total trading by volume on the TSX in 2005 to the end of July, compared to approximately 1.5% of total trading by value and approximately 2% of total trading by volume on the NYSE in interlisted securities over the same period. Such "leakage" from the coverage of the Reg NMS order protection rule therefore appears to have been considered immaterial by the SEC, and so the SEC did not extend the order protection rule to foreign trading. Furthermore, as noted above, the price discovery function is significantly more important in Canadian equity trading markets because they are comparatively less deep and liquid than U.S. equity trading markets. RS therefore believes that **Canadian regulators cannot ignore the impact that omitting foreign trading from trade-through obligations would have on the Canadian investors and marketplaces that the trade-through rule is designed to benefit**.

RS acknowledges that this supplementary obligation on market participants, combined with a marketplace-level obligation, would result in the regulatory burden being imposed at both levels. The inability of the marketplace-level solution to address trading outside Canada, and the resulting need to impose obligations directly on market participants, is a shortcoming of that approach that must be considered.

8. Key Issues

RS believes that two key issues require further research and analysis in the context of the current debate. RS is performing research that will address each of these issues, and will set out its research findings in its second comment in October.

(a) The Impact of Trade-Through Obligations on Innovation and Competition

As noted above, RS believes that investor protection should be the primary concern of regulation in this field. However, **RS also agrees that regulation should avoid any unnecessary impairment of the potential for innovation and competition among marketplaces**. RS believes that there are two distinct issues under this general heading of innovation and competition: (i) the impact on innovation and competition of trade-through obligations *per se*, and (ii) the impact on innovation and competition of different methods of implementing trade-through obligations (i.e., participant-level vs. marketplace-level solutions).

Impact of Trade-Through Obligations *Per Se*

The Discussion Paper asks whether trade-through obligations impede competition by protecting incumbent markets with "monopolistic" positions, or stifle innovation by forcing new marketplaces to adopt the same business model as existing exchanges. These are familiar assertions, but the Discussion Paper does not provide any concrete explanations of how trade-through obligations themselves (as opposed to alternative methods of implementing trade-through obligations) would in fact have this effect.

For example, the Discussion Paper states that "some believe that if new marketplaces are designed to allow institutions to trade with each other directly, they should not have to 'take out' better-priced orders on the traditional marketplace, especially if it has [a] monopolistic position, because such a requirement would affect their ability to execute their trade on the marketplace of their choice".[15] However, an obligation to displace better-priced orders would have this effect only if it was also the case that orders on the traditional marketplace were consistently better-priced than orders on the chosen marketplace for reasons unrelated to the relative quality of price discovery on the two marketplaces. If the traditional marketplace provides superior price discovery, in the form of more aggressively-priced orders, it is not anticompetitive for those orders to prevail in the competition among orders.

RS is not aware of an argument that provides this necessary link in the argument that trade-through obligations protect traditional marketplaces, unless a further argument is made that market integrity rules should permit different price discovery mechanisms that could lead to persistently different prices for the same security on different marketplaces. (Arbitrage activity that would eliminate such price differences would be constrained to the extent that one or more marketplaces restricted access to certain types of investors or required trades to have certain characteristics.) **Permitting this level of fragmentation should be discussed directly, rather than serving as an unstated assumption in the debate**.

Similarly, no marketplace need have a monopoly on trade-through protection: RS believes that the obligation to displace better-priced orders should apply equally to better-priced orders on any marketplace – traditional or non-traditional – that discloses such orders.

The Discussion Paper also states that "some argue that enforcing trade-through protection may stifle competition and innovation. By implementing a trade-through obligation on all marketplaces, new marketplaces may be forced to adopt the same business model as the existing exchanges, functionally eliminating innovation."[16] Again, the Discussion Paper does not provide any concrete examples that illustrate this point. **No current or prospective marketplace has stated that its business model is dependant on trading through better prices on other marketplaces**, although certain business models may increase the risk of trade-throughs occurring on the marketplace. Furthermore, this is a more relevant argument in the U.S., where the existence of

[15] Discussion Paper at 6341.
[16] Discussion Paper at 6341.

automated and incumbent non-automated markets gives rise to issues that do not exist in Canada, where all markets are automated.[17]

RS acknowledges that other, more valid arguments may exist that trade-through obligations *per se* impede competition and/or innovation. RS's research will attempt to identify and assess all possible arguments that trade-through obligations have this effect.

Impact of Alternative Methods of Implementing Trade-Through Obligations

RS acknowledges that there are important competitive issues to be considered in relation to alternative methods of implementing trade-through obligations.

Specifically, a marketplace-level solution that required electronic connections between marketplaces could reduce the incentives that market participants would have to join a new marketplace. Where market participants know that they will have access to better-priced orders on all marketplaces as a result of electronic connections among marketplaces (i.e., through order routing by marketplaces or some other method), there will be less incentive for them to incur the initial and ongoing costs to join a new marketplace, since doing so will not be necessary to access those orders. Similarly, market participants will know that orders placed on that new marketplace will interact with their better-priced orders. These issues would likely be most significant at the time that a new marketplace is attempting to establish its customer base. On the other hand, under a participant-level solution each market participant would have to join a new marketplace if it wanted to access that marketplace's orders, creating a push towards the development of a customer base for the new marketplace.

It must be remembered, however, that this analysis is simplistic and does not take into account the other unique and innovative business features that any new marketplace would offer (such as anonymity, the ability to trade large blocks of securities, etc.) that would encourage a market participant to access that marketplace. Furthermore, electronic connections among marketplaces will not give marketplace participants access to the full depth of the liquidity on a new marketplace (since only better-priced orders would be subject to order routing), so to the extent that a new marketplace succeeds in establishing sufficient liquidity within the existing spread, market participants will have incentives to join that marketplace.

What is not clear is whether these concerns support the participant-level solution, or whether they instead represent a concern that should be taken into account in designing a marketplace-level solution. For example, in the U.S., ATSs imposed access fees in response to this situation, and the SEC has now regulated access fees under Reg NMS.

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[17] Support for this proposition is provided by a review of the article cited in the Discussion Paper. In "Why Some Dealers and Exchanges Have Been Slow to Automate" ((2004) 60(4) Financial Analysts Journal 15) Thomas Peterffy and David M. Battan use the Intermarket Trading System ("ITS") trade-through rule as an example of regulation that creates a disincentive for manual markets to automate. The ITS rules will be replaced by the order protection rule under Reg NMS. In a postscript to the article, the authors support the order protection rule. The authors' position on the order protection rule is less important for the current discussion than the fact that their thesis relates to automated vs. manual markets, an issue which does not arise in the Canadian context.

RS's research will include a review of this specific issue, as well as identifying and assessing other arguments that different methods of implementing trade-through obligations may have different consequences for innovation and competition.

(b) The Relevance of Reg NMS and Associated Empirical Studies

As the Discussion Paper notes, the same securities have not traded on multiple marketplaces in Canada since 2000.[18] As a result, there is little current Canadian data on the incidence and impact of trading through on Canadian marketplaces.

In contrast, the debate in the U.S. relating to Reg NMS was accompanied by extensive data on trading through on U.S. markets, detailed SEC studies of those data, and equally detailed critiques and defences of the SEC studies by commenters on the Reg NMS proposal and reproposal. In addition, in the final release of Reg NMS two of the five SEC commissioners dissented, in part based on their concerns with the methodology and the implications of the SEC's statistical studies.

The differences between the U.S. and Canadian markets also mean that the U.S. data and findings based on those data cannot be directly applied to the Canadian market. However, **in the absence of any Canadian trade-through data of similar scope, it is sensible to determine what use can be made of the U.S. and international data and analysis that are available**.

RS's research will review and assess the existing literature, including the SEC's empirical studies, to identify those elements that can inform and advance the Canadian debate.

9. Conclusion

RS's support for trade-through obligations that benefit investors on Canadian marketplaces is consistent with the premise underlying UMIR that a fair and orderly market is one which respects the notion that the best-priced orders should trade first as investors' orders compete for execution.

RS's position throughout this debate has been that the regulation of market structure should, above all other goals, protect investors, and that other benefits of allowing market forces to operate, such as promoting innovation and competition, should be pursued only to the extent that they are compatible with investor protection. RS also seeks at all times to ensure that its regulatory requirements are marketplace-neutral, and that its regulatory requirements create a level playing field among market participants.

[18] Discussion Paper at 6335.

In conclusion, RS looks forward to continuing to work with the CSA to address the important issues relating to market structure and trade-through obligations set out in the Discussion Paper on a basis that is informed by rigorous theoretical and empirical analysis.

Yours truly,

Tom Atkinson

Tom Atkinson
President & CEO

APPENDIX A
RS PARTICIPATION IN THE POLICY PROCESS

RS believes that it is important that the public record be complete and accurate respecting recent events relating to trade-through obligations. This Appendix provides background on RS's participation to date in the policy process, and RS's response to certain aspects of the CSA's analysis presented in the Discussion Paper of the Trade-Through Amendments.

RS first raised the issue of the application of trade-through obligations in the context of multiple marketplaces more than one year ago in MIN 2004-018 – *Provisions Respecting "Off-Marketplace" Trades* (August 20, 2004), a package of proposals which included the Trade-Through Amendments. Given the importance of the trade-through issue, the Trade-Through Amendments were separated from that package of proposals and included in a proposed interim solution set out in MIN 2005-016. With the prospect of multiple marketplaces trading the same securities, RS proposed the Trade-Through Amendments as an interim measure to ensure that each person with access to the Canadian equity markets would be subject to the same trade-through obligations. RS believes that the status quo – in which trade-throughs do not occur on Canadian marketplaces – should not be changed by the introduction of multiple marketplaces without the benefit of a public debate regarding the continued importance of the neutral application of trade-through obligations.

In April and early May of 2005, RS determined that the introduction of multiple competitive marketplaces, in circumstances where the status quo of neutral trade-through protection was not respected and enforced, represented a substantial risk of material harm to marketplaces and those persons having trading access to marketplaces. For this reason, RS provided notice to the Recognizing Regulators that it intended to seek the immediate implementation of the Trade-Through Amendments. On May 12, 2005, the Recognizing Regulators provided notice that they did not agree that immediate implementation of the Trade-Through Amendments was necessary at that time. RS therefore published the Trade-Through Amendments for public comment and implementation as an interim measure to preserve the status quo – in which trade-throughs do not occur on Canadian marketplaces – during the present CSA review.

At the time that the Recognizing Regulators rejected immediate implementation of the Trade-Through Amendments, the OSC issued a news release stating that the Recognizing Regulators would issue the discussion paper and provide a 90-day comment period following the publication of the discussion paper, "with a proposed solution to be in place by the fall."[19] If it is no longer the case that a comprehensive CSA solution can be in place by this deadline, **RS strongly urges the CSA to implement some form of interim trade-through protection in order to preserve the status quo – in which trade-throughs do not occur on Canadian marketplaces – and to ensure that investors are protected by neutral trade-through obligations while the CSA analyzes the alternatives**.

[19] "Securities Commissions to Consult on Market Structure Rules – Concept Release Planned for June" (OSC news release, May 12, 2005).

RS is, during the CSA review, monitoring the incidences of trade-throughs that occur on marketplaces regulated by RS and reporting this information to the Recognizing Regulators. RS will also enforce the existing trade-through rules against any Participant that intentionally trades through a better-priced order. If RS concludes, based on the level of trade-throughs or the patterns of trade-through activity that emerge, that material harm to retail and other investors, marketplaces or to those persons having trading access to marketplaces can be demonstrated to the Recognizing Regulators, RS may request again that the Recognizing Regulators approve the immediate implementation of the Trade-Through Amendments if, at that time, the CSA has not implemented an interim or final solution.

The Trade-Through Amendments proposed by RS were designed to impose neutral trade-through obligations on both Participants and Access Persons. RS proposed the Trade-Through Amendments to protect investors and to ensure that there was a level playing field among market participants and marketplaces in the application of trade-through obligations. The Discussion Paper contrasts this participant-level approach with the approach that imposes the trade-through obligation at the marketplace level. In fact, RS outlined this marketplace-level alternative in MIN 2005-016, where RS stated that:

> The Board recognizes that there are a number of ways to achieve the neutral application of trade-through obligations. Trade-through obligations could be equalized by the Trade-Through Amendments, which would amend UMIR to make them apply to all parties, including Access Persons, with access to Canadian marketplaces. Alternatively, trade-through obligations could be equalized by an amendment to the Marketplace Operation Instrument and/or the Trading Rules that would require each marketplace to implement policies and procedures to prevent trading through on that marketplace. Neither the Marketplace Operation Instrument nor the Trading Rules currently imposes any trade-through obligations on marketplaces and these instruments may be amended only by the applicable securities regulatory authorities.[20]

As the Discussion Paper notes, a marketplace-level obligation has several superficial advantages over the participant-level obligation proposed in the Trade-Through Amendments. RS is aware of these advantages, but did not choose one approach over the other because RS does not have the authority to impose a solution requiring an amendment to CSA instrument, including imposing a marketplace-level obligation. The Trade-Through Amendments therefore represented RS's only legitimate avenue to preserve the status quo – in which trade-throughs do not occur on Canadian marketplaces – during a public debate on trade-through issues in the absence of CSA action to address the emerging situation.

RS would also like to respond briefly to certain aspects of the CSA's analysis of the Trade-Through Amendments presented in the Discussion Paper.

First, RS was aware that the Trade-Through Amendments would not be able to eliminate trade-throughs completely (because the trade-through obligation would apply in respect of orders only on those marketplaces to which a market participant has access), and were also subject to the limits on RS's jurisdiction as a regulation services provider, and

[20] MIN 2005-016 at 5070.

therefore represented a second-best solution. However, the Trade-Through Amendments would have been effective as an interim solution, in the absence of a timely CSA response to the introduction of multiple marketplaces, to eliminate most trade-throughs and would have applied equally to Participants and Access Persons. RS agrees that a broader scope of trade-through protection may be an advantage of a marketplace-level obligation, subject to supplementing that obligation with trade-through obligations applicable to marketplace participants trading on markets outside of Canada. Even under a participant-level solution, however, there would be practical limits on an investor's willingness to voluntarily restrict its access to the liquidity available on a marketplace solely to preserve its ability to trade through better prices on that marketplace.

Second, RS is aware that Access Persons (large institutional investors, small institutional investors, sophisticated retail investors and unsophisticated retail investors) would vary widely in their capabilities and proficiency in complying with the Trade-Through Amendments. However, this is true of many other UMIR requirements that apply to Access Persons.[21] This does not mean that these provisions also should not apply to Access Persons. Instead, the responsibility to ensure proficiency lies with the marketplace. The class of investors with access to a marketplace is determined by the marketplace, subject to CSA approval of its rules and policies, and it is the marketplace's responsibility to ensure that each Access Person with access to that marketplace is trained in the UMIR provisions that apply to that Access Person.[22] Even under a marketplace-level obligation, however, it would still be necessary for marketplace participants to understand and comply with their continuing obligations under UMIR generally, and with respect to their trade-through obligations when trading on markets outside Canada specifically.

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[21] These include prohibitions on manipulative and deceptive methods of trading, short-sale restrictions and audit trail requirements.
[22] UMIR s. 7.2(2).