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BY E-MAIL and COURIER

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Dear Members of the Canadian Securities Administrators,

Re: Discussion Paper 23-403 – Market Structure Developments and Trade-through Obligations

TSX Group Inc. (TSX Group) welcomes the opportunity to comment on Discussion Paper 23-403 – Market Structure Developments and Trade-through Obligations (Discussion Paper) published by the Canadian Securities Administrators (CSA). We respond generally to the Discussion Paper in this letter. In Appendix I we respond to the questions asked in the Discussion Paper.

TSX Group owns and operates Canada's two largest national equities exchanges – Toronto Stock Exchange serving the senior equity market and TSX Venture Exchange serving the public venture capital market. We believe that clarifying the nature, extent, and execution of trade-through obligations is vital to Canadian equity capital markets. Investors large and small should know with clarity how their orders will be dealt with by all marketplaces in Canada. Despite the fact that categories of issuers may be afforded differing treatment based on their size or industry sector when raising capital in the primary market, once an issuer's securities are listed or posted for secondary trading on a Canadian marketplace there must be a uniform body of trading principles that fosters market integrity and promotes investor confidence in the fairness of the Canadian equity market. Investors need certainty and deserve to know that when they enter an order on any Canadian marketplace to buy or sell an issuer's securities, their better-priced order will be executed before inferior-priced orders on any marketplace. It is this certainty that will enhance price discovery, attract liquidity, and make Canada a destination for trading by Canadian and non-resident investors alike.

Trade-throughs: Harmful to the Canadian Marketplace

We believe that all better-priced orders that are visible on any Canadian marketplace should be filled before an inferior-priced order is executed on any marketplace because the prohibition against trade-throughs is a market principle that should transcend marketplaces. As in the U.S. under Reg. NMS, this obligation should only apply to trading done on marketplaces where the trades are immediately executable. That is, only those orders displayed on an immediate and automatically accessible marketplace should be protected.

A common goal of Toronto Stock Exchange and TSX Venture Exchange is to build liquidity and depth of market in their central order books. Achieving these goals improves the quality of the marketplace, as spreads narrow and the true price of a security can be gauged through a full and rigorous price discovery process. Limit orders are a necessary component of a liquid marketplace, and it is these limit orders that play a key role in the price discovery process. If inferior-priced orders are permitted to regularly execute before better-priced limit orders that are exposed on a marketplace, fewer investors will enter limit orders on a marketplace. There simply will be no benefit for them to place the limit order. A reduction in the number of orders displayed in the Toronto Stock Exchange or TSX Venture Exchange central order books will perpetuate a cycle where fewer and fewer limit orders are booked, resulting in worsening price discovery. A reduction in liquidity and poor price discovery will make Canada's capital markets less attractive to investors.

If investors lose faith in the price discovery process and the marketplace generally, this hurts all investors who look to the marketplace to determine the price of a security. Investors placing market orders and investors that trade large blocks of securities may have reservations about whether the prices quoted on the marketplace are in fact representative of the true price of the security, when they know that limit orders are not being entered by investors.

A number of rules set out in the Universal Market Integrity Rules (UMIR) use the concept of "last sale price". These rules include the market stabilization and short sale rules. The last sale price has been generally accepted as the best representation of the true price of a security at a point in time. If trades can be executed by trading-through better-priced bid or ask prices, then the last sale price will no longer represent a valid approximation of a security's market value. Thus, the weakened price discovery mechanism and poor representation of "last sale price" that could result by allowing trade-throughs to occur will have a direct negative impact on UMIR and on Market Regulation Services Inc.'s (RS) ability to monitor and enforce UMIR.

Furthermore, under the order exposure rule outlined in Rule 6.3 of UMIR, if a participant receives a client order for 50 standard trading units or less with a value of $100,000 or less, subject to certain exceptions, this client order must be entered on a marketplace. This rule was designed to, among other things, support price discovery. Allowing certain orders to execute before better-priced orders on a marketplace undermines the rationale for requiring order exposure.

When we compare the Canadian market to foreign markets, we believe that Toronto Stock Exchange and TSX Venture Exchange have relatively strong retail participation levels, and therefore better price discovery, than certain other exchanges. The London Stock Exchange (LSE) is a useful exchange for comparison purposes because its number of listed issuers is similar to the number of issuers listed on Toronto Stock Exchange and TSX Venture Exchange combined. The average trade size (by number of units) on the LSE is approximately 6 times larger than the average trade on Toronto Stock Exchange and TSX Venture Exchange combined.[1] When comparing trades effected per dollar of issuer market capitalization, there are almost twice as many trades on Toronto Stock Exchange and TSX Venture Exchange combined than on the LSE.[2] Given these facts, it is not surprising that retail investor participation in Canada is twice as high as in the U.K.[3] As stated in a 2001 U.K. publication discussing the incidence of trade-throughs in that country:

> "a degree of price fragmentation has long been accepted as the norm in certain parts of the UK market, notably the equity market. It remains the case that institutional trades are conducted at prices that are different to, and generally better than, the prices for retail trades."[4]

TSX Group believes that the CSA should strive to have the marketplaces in Canada operate in a manner where all orders, retail or institutional, small or large, should be able to execute at the best price available. Institutional investors do not need to receive any further advantages, to the detriment of retail investors, from Canadian marketplaces.

TSX Group is concerned that any movement away from the Canadian tradition of protection for better-priced orders could benefit unregulated marketplace participants, such as hedge funds, to the detriment of other investors. The growth in hedge fund trading is a recent development in the Canadian market. We submit that as of today, no one fully understands the impact that hedge fund trading will have on our market. However, it is quite clear that one of the main beneficiaries of relaxed trade-through regulation will be unregulated hedge funds that may be able to exploit regulatory loop holes to the disadvantage of other Canadian marketplace participants.

TSX Group believes that price protection should be accorded without prejudice to all orders, regardless of size. In the first quarter of 2005, block trades[5] comprised approximately 1.8% of all trades executed and approximately 38.5% of the total value traded on Toronto Stock Exchange. Price discovery on Toronto Stock Exchange is not driven by block trades, rather it is driven primarily at the margin by the quantity and frequency of non-block orders.

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[1] World Federation of Exchanges, *Monthly Statistics for 2004 and 2005 (year to date).*
[2] Ibid.
[3] Australian Stock Exchange, *International Share Ownership: Key Highlights*. Australia. 2002.
[4] Board, Sutcliffe and Wells, *Orderly Markets: Regulation in a Changing Environment*. U.K. 2001.
[5] For purposes of this letter, "block trade" means an executed trade for 10,000 or more shares.

The small order provider's voice must be heard throughout this debate, as it is the small orders that will be traded-through if price protection for better-priced orders is not enforced. To substantiate this assertion, we reference a 2004 Securities and Exchange Commission (SEC) publication.[6] Over a four day sample period, trade-throughs on the New York Stock Exchange (NYSE) and NASDAQ were studied. Over 65% of the orders on the NYSE that were traded-through and over 40% of the orders that were traded-through on NASDAQ were for orders of 100 or fewer shares.

In Canada within the past month, there have been trades executed on an ATS at an inferior price to orders displayed on Toronto Stock Exchange. If uniform trade-through protection across marketplaces is not mandated, we believe that trade-throughs will occur with frequency and will not be limited to certain specific instances.

Duty Owed to the Market

The obligation to honour better-priced orders is an obligation that marketplace participants owe to the market. In this regard, we agree with the assertion made by RS in its May 12, 2005 Request for Comments – Interim Provisions Respecting Trade-Through Obligations (RS Paper). This is not a fiduciary duty owed by a dealer to its client, or by an asset manager to its account, rather this is a duty owed to the market generally by all marketplace participants. This duty is fulfilled by honouring all better-priced orders in the market. As noted in the RS Paper, this duty to the market was specifically set out by Toronto Stock Exchange in its Board of Governors' Ruling #90-08. This Ruling confirmed that a member's Canadian client accounts, as well as its principal accounts were covered by this obligation:

> 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 ruled 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.
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> …Members may not intentionally trade through a better posted bid or offer on the TSE by making a trade at an inferior price (either one-sided or a put-through) on another exchange. This rule applies even if the client consents to the trade on the other exchange at the inferior price. Members may make the trade on that exchange if the better bids or offers, as the case may be, on the TSE are filled first, or coincidentally with the trade on the other exchange.
>
> Members are also reminded of their responsibility not to trade through better bids or offers on other Canadian exchanges.
>
> …This ruling applies to trades for Canadian accounts and members' principal (inventory) accounts.

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[6] Office of Economic Analysis, Securities and Exchange Commission. *Analysis of Trade-Throughs in NASDAQ and NYSE Issues*. U.S. December 15, 2004.

Basic Requirements of a Trade-Through Rule

Any Canadian trade-through rule must ensure that all better-priced orders (that is, the full depth of book) are protected. This is consistent with the Toronto Stock Exchange's historical view. The SEC's decision, through Reg NMS, to protect only top of book reflects a hard-fought compromise solution in a country where, historically, trade-through protection was not a market imperative. The SEC's compromise solution may have served the interests of certain groups, but not that of the U.S. market as a whole.

There is no logical reason why a bid that is one penny less than the best price should be traded-through. Top of book protection does not eliminate the free-riding on limit orders that provide price discovery. The goal of marketplaces everywhere is to have a strong price discovery mechanism and trades that occur at the true price of a security. This is done by having numerous orders lining the central order book with very tight spreads between the best bid and best ask prices, and very small gaps between the prices on each side of the central order book. When this scenario is achieved, the marketplace will have an excellent price discovery process and ample liquidity for its securities, which benefits all investors.

When better-priced limit orders, whether at the top of the book or not, can be traded-through, there is no incentive to layer the central order book with limit orders that are just below the best bid price or just above the best ask price. If the incentive does not exist, investors will not enter limit orders and the marketplace will not be as liquid and robust as a result.

Only better-priced orders that are visible to marketplace participants should be honoured. Orders entered on marketplaces that operate a continuous blind book, and orders with undisclosed volumes, such as the undisclosed portion of an iceberg order on Toronto Stock Exchange should not be given better-price standing, and therefore could be traded-through. However, marketplace participants entering orders in a blind continuous book or orders with an undisclosed volume, would be expected to ensure that these orders do not by-pass better priced orders.

Of course, there will be exceptions to the general rule. There should be carve outs from the trade-through obligation for certain order types. Specifically, the obligation should not apply if the order is one where the price cannot be known upon order entry, such as, Call Market Orders, Market on Close Orders, Volume-Weighted Average Price orders or Basis Orders (all as defined in UMIR). This exception should not extend to orders whose price is directly pegged to order prices exposed on the central order book of a marketplace. For example, if an algorithm derives a limit order price by calculating it as being two cents less than the best bid price on a marketplace, that order should not be permitted to trade through a better-priced bid in any marketplace simply because the order was not entered as a pure limit order, but rather as a calculation based on existing prices in the central order book.

Certain special terms orders should also be exempt from the better-price obligation. Special terms orders that do not impact the last sale price and do not execute in the central order book (such as orders with special settlement terms like delayed delivery, or orders marked as "non-resident") should not be honoured as better-priced orders and similarly they should be exempt from the better-price obligation.

However, special terms orders that are used to establish the last sale price because they execute in the central order book should not be exempt from the obligation to honour better-priced orders, although these types of special terms orders themselves can be traded-through if they are entered on a non-visible book of a marketplace.

Trade-Through Obligation: Participant Obligation

The obligation not to trade-through better-priced orders is owed by a marketplace participant. That is, the person entering the order must be responsible for the order and is accountable to ensure that the order does not trade-through better-priced orders.

While the responsibility for ensuring compliance with this obligation could rest with either the marketplace or the marketplace participant, we believe that the practical obligation not to trade-through better priced orders should remain with marketplace participants. This may not be the perfect solution, but we believe that it is the best solution, after giving ample consideration to the alternatives. The obligation arises at the time the order is entered unless the order is entered on a non-visible marketplace, in which case the better-price obligation would be fulfilled immediately after the original inferior-priced order is executed. We acknowledge that this may be difficult to execute and monitor in a market that has multiple marketplaces, but we believe that it is the solution that best represents the marketplace participants' duty.

Participating Organizations on Toronto Stock Exchange and TSX Venture Exchange are able to link directly to our trading systems, as are certain eligible clients through sponsored direct access technology. As well, Toronto Stock Exchange can work with ATSs to ensure those trades can be printed on Toronto Stock Exchange and attributed to the ATS. We believe that our systems allow marketplace participants to build technology that can efficiently link to our exchanges, while enabling them to be compliant with their obligation to honour better-priced orders. Further, the unattributed order is a Toronto Stock Exchange feature that will allow marketplace participants to execute against better-priced orders while remaining anonymous. We believe that this feature and the ability of certain marketplace participants to access Toronto Stock Exchange by sponsored direct access minimize the possibility of information leakage. To this point, we submit that if trade-through obligations are not enforced on all marketplace participants, any information leakage that does occur will not be as easily recognized by the regulators because the trades resulting from information leakage may be disguised somewhat by trade-throughs occurring between marketplaces.

As proposed in the RS Paper, we believe that the trade-through obligation should be imposed on marketplace participants that trade directly on an exchange, subscribers to a marketplace, and clients that trade by sponsored direct access on a marketplace.

We do not believe that marketplace participants should be forced to trade on those marketplaces to which they are not already directly connected. For example, if an investment dealer is a dealer on CNQ but not on TSX Venture Exchange, it should not be forced to trade on TSX Venture Exchange even if TSX Venture Exchange is posting a better-priced bid or ask. However, we agree with the assertion made in the RS Paper that those investors that access a marketplace through sponsored direct access should be required to honour better-priced bids and asks on that marketplace. For example, if a client is a subscriber to an ATS but is also a sponsored direct access client on Toronto Stock Exchange, it must look to both marketplaces to determine the better-priced bids and asks.

We do not believe that marketplace participants should be forced to honour better-priced bids and asks on marketplaces where the bids and asks are not visible. Similarly, we do not believe that marketplace participants should be required to honour the undisclosed portion of an order in a marketplace.

We support the approach taken in the RS Paper with regard to determining whether a marketplace participant has made “reasonable efforts” to honour better-priced orders displayed in a consolidated market display (as currently defined in UMIR). We agree that: whether the marketplace participant has access to the marketplace with the better-priced order; the costs associated with accessing such order or orders; and whether the marketplace participant has met applicable obligations under Part 2 of Policy 2.1 of UMIR to move the market are relevant factors in determining whether a marketplace participant has taken “reasonable efforts” to fill better-priced orders.

In the Alternative: Marketplaces Provide the Mechanism

Given the complexities and costs that could arise if the obligation to enforce price protection is formally placed with marketplace participants, we understand that the CSA may impose the responsibility for compliance with the trade-through obligation on marketplaces. That is, although the duty to honour better-priced orders is owed by the marketplace participant, the CSA may determine that the better model to ensure that price protection will exist among Canadian marketplaces is a model whereby the execution strategy is set at the marketplace level. Effectively, the marketplaces, as a function of their public interest mandate, would provide a service that will allow marketplace participants to know that their price protection duty will be automatically fulfilled each time they enter an order on a Canadian marketplace. The onus to build systems to fulfill the marketplace participants’ duty will fall to the marketplaces rather than to the marketplace participants. Marketplaces will be the mechanism that sets and enforces the business rules that will ensure price protection.

If the obligation is to be executed by the marketplaces, they could link electronically and, through technology, ensure that inferior-priced orders are not trading-through better-priced orders. A significant technology investment will be required by the marketplaces if they need to connect their systems in order to ensure that better-priced orders are not traded through on any marketplace.

If the CSA agree that the obligation should rest with the marketplace, we submit that the CSA look to Reg. NMS as a useful precedent. Specifically, the requirement that the trading centres are required to establish policies and procedures that are reasonably designed to prevent trade-throughs, seems to be a logical approach when imposing the obligation on the marketplaces. In addition, many of the Reg. NMS exceptions from price protection obligations will be relevant to the Canadian market (such as single-priced opening or closing transactions).

If the obligation is imposed on the marketplaces, we believe that the marketplaces should determine how the linkages should occur, in order that they can decide on the most efficient and cost-effective model.

Competition Among Marketplaces: Recent History

In 1999, by Memorandum of Agreement, the Alberta Stock Exchange (ASE), Vancouver Stock Exchange (VSE), Montreal Exchange (ME), and Toronto Stock Exchange (on its own behalf and on behalf of Canadian Dealing Network (CDN)) agreed to restructure their trading facilities. This was done to enhance the efficiency of the trading facilities and services of the exchanges and improve the competitive position of the Canadian securities industry in the context of globalization of the securities and derivatives markets. The restructuring resulted in Toronto Stock Exchange operating the senior equities exchange in Canada and the ME operating the derivatives exchange in Canada. A resulting merger of the ASE, VSE, and CDN resulted in the creation of Canadian Venture Exchange (CDNX), operating the junior equities exchange in Canada. In 2001, Toronto Stock Exchange acquired CDNX which now operates as TSX Venture Exchange. The 1999 restructuring and subsequent acquisition of CDNX by Toronto Stock Exchange was intended to eliminate fragmentation of the Canadian market and leverage the strength of each exchange through specialization. In 2002, after having demutualized in 2000, Toronto Stock Exchange underwent a restructuring which resulted in a holding company structure and the initial public offering of shares of TSX Group, the parent company of TSX Inc., which in turn is the parent of TSX Venture Exchange Inc.

To provide an example of how global competition among marketplaces can benefit marketplace participants, and ultimately investors, we can look to Toronto Stock Exchange's trading fee reductions since the 1999 restructuring. In 2000, Toronto Stock Exchange migrated to an active/passive fee model whereby active orders (such as market orders or immediately executable limit orders) were charged a fee, and passive orders (such as limit orders entered into the central limit order book that participate in the price discovery process) were free. In 2002, the per trade cap was lowered significantly from $80 per trade to $50 per trade. In 2003, trading fee credits were provided to market makers. In 2004, a trade-based discount model was added as an alternative to the existing value-based discount model. In January 2005, access fees were reduced for a trial period. Effective September 1, 2005, the access fee reductions were made permanent. These changes had the effect of eliminating access fees for order entry connectivity. Toronto Stock Exchange has also announced a fee change, effective October 1, 2005 for a one-year trial basis, on issues that are interlisted on Toronto Stock Exchange and either NASDAQ or the American Stock Exchange. As well, we have announced fee changes to the current value based fee system for all other issues listed on Toronto Stock Exchange that will come into effect in two phases: on October 1, 2005 and January 1, 2006. We anticipate that these fee changes will have the result of reducing the cost of trading by Participating Organizations (POs). The cost of trading has declined over time because Toronto Stock Exchange has been able to create internal efficiencies and pass the benefits of these efficiencies on to its customers.

During the same time period, Toronto Stock Exchange introduced a number of trading initiatives as a response to global competition that provided more choice to investors and made the marketplace more efficient. These include the introduction of iceberg orders, voluntary attribution, after hours crossing, specialty priced crosses, U.S. Dollar Book, market making reform, Market-On-Close, multiple give-up. Again, it is clear that global competition drives the introduction of innovative products and enhances marketplace efficiencies. TSX Group expects that the global pressure that drives our exchanges to create efficiencies will continue indefinitely and will intensify over time.

We believe that the specialization that began with the 1999 restructuring was the start of an evolution that has allowed Toronto Stock Exchange and TSX Venture Exchange to compete on a global scale. Our exchanges operate in a highly competitive global environment and we welcome such competition. Toronto Stock Exchange currently competes with the NYSE and NASDAQ – two of the largest exchanges in the world. Because our global competition is larger than us, we are driven to be innovative and efficient in order to stay competitive. With the recent merger announcements as an example (NYSE with Arca, and NASDAQ with Instinet), we believe that our global competitors will continue to grow in size and become even more formidable. It is this competition, not synthetic competition derived from regulatory arbitrage, which will allow our markets to grow and meet the needs of our customers.

CSA Objective – Balancing Regulation and Competition

The Discussion Paper identifies specific objectives as factors that should be considered in identifying the appropriate trade-through structure for Canada. The first objective is to balance regulation and competition among all types of marketplaces. At the outset, we submit that the discussion about competition has been framed too narrowly. Competition between marketplaces generally benefits broker-dealers. The benefits attained by these industry participants may or may not be passed along to their customers. However, it is competition between orders that creates the best results for investors. This element of competition has not been explored in the Discussion Paper. William Donaldson, then Chairman of the SEC, during his testimony concerning proposed Reg. NMS in 2005 stated, "the importance of competition among markets for trading services is self-evident, yet competition among orders is at least as important, for this competition to be the best price produces narrow spreads and deep liquidity".[7]

When balancing competition among marketplaces, we urge the CSA to ensure that their actions will result in a more efficient and effective trading experience for Canadian investors. We believe that former SEC Chairman Donaldson's warning should be heeded: "competition among multiple markets simultaneously can interfere with competition among orders in those stocks, thereby detracting from the quality of price discovery and leading to reduced market depth and high volatility".[8] Market fragmentation can also negatively affect issuers. As price discovery is diminished, the bid-offer spread widens. A wider spread implies a higher cost of equity and commensurately higher cost of capital for issuers, which results in a valuation discount.

Competition occurs today at a global level. Both Toronto Stock Exchange and TSX Venture Exchange are in constant competition with exchanges, quotation and trade reporting systems, OTC bulletin boards, electronic communication networks, and alternative trading systems in the United States and abroad. For example, there are currently 212 Toronto Stock Exchange-listed issues that are also listed on NYSE, NASDAQ and the American Stock Exchange. These inter-listed issues represent approximately 53.9% of the number of trades executed on Toronto Stock Exchange and approximately 59.3% of the total value of trades executed on Toronto Stock Exchange.[9] These statistics show that Toronto Stock Exchange is in constant competition with U.S. marketplaces to ensure that order flow on these issues remains north of the border.

Any regulatory rule changes to the Canadian market will not only affect competition among marketplaces within Canada, but will also affect competition between Canadian- and U.S.-based marketplaces. The CSA must ensure that the Canadian regulatory framework does not penalize Canadian-based marketplaces while providing an advantage to their U.S. competitors. This imperative is as important as, if not more important than, balancing marketplace competition within Canada. The CSA should ensure that Canadian marketplaces can be structured and operated in a manner that will allow them to remain competitive with other

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[7] Donaldson, William H. *Testimony Concerning Proposed Regulation NMS.* USA. 2003
[8] Ibid.
[9] Based on year-to-date data as at August 31, 2005.

marketplaces, so that issuers (domestic and foreign) will choose to list on them, and investors (domestic and foreign) will choose to trade on them.

We believe that the CSA must recognize that the imposition of a trade-through policy in the U.S. through Reg. NMS will have an effect on the Canadian marketplace. If the U.S. has a trade-through rule and Canada does not, this divergent regulation will be harmful to Canadian capital markets. If investors have less faith in the fairness of our market and the depth of our price discovery as compared to the U.S. market, orders flow will not migrate to our market. Further, the U.S. solution was clearly a compromise to satisfy the disparate views of certain investors as well as differing views of marketplaces. We believe that Canada should be consistent with its history, and follow former SEC Chair Donaldson's original (uncompromised) assertion that full depth of book protection be given to all better-priced orders.

CSA Objective –Support Retail Participation

The Discussion Paper also states that one of the CSA's objectives is to recognize and support the role of retail participation in the market. The retail investor and his or her treatment are of the utmost importance to TSX Group. The retail investor, with small-sized orders, contributes to the price discovery mechanism of exchanges. However, it is also vital to recognize that it is not just the retail investor who adds liquidity to the market through small orders. Many other types of investors add liquidity and enhance price discovery on marketplaces by providing small-sized order flow. These investors include:

- portfolio traders
- velocity traders
- hedgers
- pro traders
- market makers
- algorithmic traders

Combined, these investors provide considerable liquidity to Toronto Stock Exchange[10]. If trade-through protection is not afforded to better-priced orders, all of these investors, not just retail investors, will reduce their limit order entry on Toronto Stock Exchange and TSX Venture Exchange, which could have a significant negative effect on price discovery and liquidity on our exchanges as well as other Canadian marketplaces. We believe that it is critical that the CSA recognize and support all investors that place small orders on Canadian marketplaces.

Market makers, for example, foster price discovery and enhance liquidity by entering small orders on Toronto Stock Exchange. Given their roles, they are dependent on price protection for their livelihood. Market makers who are dependent on price protection would lose the incentive to provide narrow spreads if price protection is not enforced. If trade-throughs are allowed to occur, spread goals will deteriorate, price discovery will be hampered, and the overall quality of market making services to Toronto Stock Exchange will be diminished. This would harm all marketplace participants, including, ultimately, institutional order flow.

[10] In the first quarter of 2005, approximately 78.5% of all trades executed on Toronto Stock Exchange were for fewer than 1000 shares.

CSA Objective – Encouraging Innovation

The Discussion Paper also articulates another of the CSA's objectives as being to encourage innovation. It is important to understand that market innovation is not driven by the ability to execute trades at any price. Innovation at Toronto Stock Exchange and TSX Venture Exchange has recently been driven by competition in the global capital markets. Our exchanges will continue to innovate to remain competitive globally, to ensure that issuers will continue to choose to have their securities traded on our facilities. For example, as outlined above under the heading *Competition Among Marketplaces: Recent History*, over the past few years, Toronto Stock Exchange introduced a number of trading initiatives as a response to global competition that provided more choice to investors and made the marketplace more efficient.

The CSA must consider what will happen to innovation in Canada if we do not protect better-priced orders, while the U.S. moves toward trade-through protection. Increasing the number of competitive marketplaces alone will not spark innovation. If better-priced orders are not protected, innovators may determine that they should not build in an environment where the regulation is perceived to be uneven, and may instead innovate in the U.S. as an alternative destination.

With respect to algorithmic trading specifically, we believe that it is important to understand that this is a growing area in which Canada already lags behind the U.S. We submit that if there is not adequate protection for better-priced orders posted on Canadian marketplaces, this will harm innovation in algorithmic trading in this country, as the small order flow typically seen in algorithmic trading will be dramatically reduced. If algorithmic trading is hampered by a lack of better-priced order protection in our markets, this could dampen liquidity in our markets, certainly as compared to liquidity in the U.S.

Closing

We believe that the Discussion Paper has raised important issues. The rights and needs of a variety of market constituents need to be balanced when considering the implication of trade-throughs in Canada. While TSX Group's views outlined in this letter may not provide a perfect solution to quiet the debate, we believe that our views represent the best solution given the complex nature of the Canadian market.

We urge the CSA to ensure that, above all else, the regulatory regime in Canada is a level playing field where marketplace participants can have certainty that their orders will be treated fairly regardless of which marketplace they are entered on. If trade-throughs are permitted, Toronto Stock Exchange and TSX Venture Exchange will have no choice but to adapt their business and trade allocation models to compete with other marketplaces. This would ensure that our customers would not be disadvantaged by regulatory arbitrage across marketplaces. However, the result could also be that few players benefit at the expense of the vast majority of other investors across Canada.

Due to the importance of this debate to the Canadian capital markets, TSX Group wishes to participate in the public forum to be held in Toronto on October 14, 2005.

Thank you for providing us the opportunity to comment on the Discussion Paper. We would be pleased to discuss with you any of the matters outlined in this letter.

Sincerely,

“Richard Nesbitt”

Richard W. Nesbitt
CEO
TSX Group

Appendix I

1. *What factors or criteria should be considered in identifying the appropriate structure and requirements for the Canadian market?*

   As we have outlined in our letter, we believe the following factors should be taken into account in developing a trade-through obligation:

   - the need to ensure the Canadian market remains competitive globally
   - the fair treatment of small sized orders (often placed by retail investors)
   - the need to attract liquidity to a perceived fair marketplace
   - the protection of depth of the book

2. *What market structure issues should be considered as part of the discussion on the trade-through obligation?*

   Please see our response to question 1 above.

3. *Should the discussion about trade-throughs consider trading of non-exchange traded securities on marketplaces other than exchanges (for example, fixed income securities trading on more than one ATS)? If so, please identify market structure issues that need to be reviewed.*

   We believe that the principle that better-priced orders exposed on a marketplace must be protected is a basic tenet that should encompass the trading of all securities in Canada.

4. *Please provide comments on the RS proposal regarding trade-through obligations. Which elements do you agree or disagree with and why?*

   We support RS' efforts to fill an existing regulatory gap. We agree that the trade-through obligation is an obligation that is owed to the market generally, and not simply a duty owed by a participant to its client. We agree that this obligation is owed by Participants and Subscribers alike (as defined in UMIR), as well as clients executing through sponsored direct access and that the responsibility for ensuring compliance with this obligation should rest with these marketplace participants. We agree that all better-priced orders should be honoured, so long as they are visible, with the exception of certain orders, as discussed in our letter and these questions. We agree that marketplace participants should only be obliged to look to the marketplaces to which they have direct access.

5. *If a trade-through obligation is imposed, what differences between Canadian and United States markets should be considered?*

   As outlined in our letter and under questions 15, a Canadian trade-through rule must provide full depth of book protection.

6. *Should trade-throughs be treated differently on derivatives markets than equity markets? Why or why not?*

   As stated in question 3 above, we believe that the principle of better-priced order protection should cover trading in all securities in Canada. TSX Group is particularly concerned with the trading of synthetic securities, including derivative equity options. If a derivative equity option is traded at a price that is outside the best bid and best offer, this could provide the opportunity for certain marketplace participants to engage in manipulative trading practices such as by-passing short sale rules and allowing for uninhibited crosses. A disconnect could develop between equity options and their respective underlying security. This disconnect could allow marketplace participants to circumvent UMIR (assuming that UMIR does not cover the derivative marketplace, as is the case currently). If a marketplace participant is able to circumvent a trade-through obligation on an equities marketplace by trading the equity's derivative on a derivatives marketplace, then the spirit of trade-through protection that exists on the equities marketplace will be defeated.

7. *Should trade-through protection be imposed where there are multiple marketplaces trading the same securities? Why? Why not? What are the advantages and disadvantages?*

   As discussed in the letter, trade-through protection should be imposed where there are multiple marketplaces trading the same securities. All visible better-priced orders must be protected, as the duty not to trade-through is owed to the market generally. If trade-through protection is not imposed, we fear that small order flow in this country will be traded-through, thereby deterring the entry of small orders which will likely lead to a weakening of price discovery and consequently will detract from the liquidity of the market.

8. *Will the trade-through obligation impact innovation and competition in the Canadian market? How?*

   We believe that clarifying a trade-through obligation could provide innovation opportunities to a variety of players in Canadian markets. For example, if the trade-through obligation lies with the marketplace participant, technology providers that can program smart order routers will be able to assist all marketplace participants in meeting their obligations. Similarly, marketplace participants could create proprietary systems to assist them in this function. If the trade-through obligation lies with marketplaces, marketplaces will be able to create systems that connect to each other, or they will be able to purchase such software from technology providers.

   Once the trade-through obligation is clarified and regulatory arbitrage cannot occur among marketplaces, we expect that marketplaces will then be motivated to create new products for investors and create efficiencies in their operating systems in order to obtain a competitive advantage.

9. *Should the trade-through obligation remain an obligation owed by dealers to their clients or should all marketplace participants owe a general duty to the market?*

We believe the trade-through obligation is an obligation that is owed to the market generally. All marketplace participants owe a general duty to the market. Please see our discussion in the letter.

10. *If a trade-through obligation is imposed, should the obligation be imposed on the marketplace participant or the marketplace? Why?*

The responsibility for ensuring compliance with the trade-through obligation should rest with the marketplace participant. We recognize that while this may not be the ideal solution, in our view it is the best solution given the complexities of the Canadian market. Please see our discussion in the letter.

11. *What technology solutions exist or need to be developed if a trade-through obligation is imposed on marketplaces? What solutions exist if the obligation is imposed, instead, on marketplace participants?*

If the obligation is imposed on marketplace participants, we would expect that marketplace participants would use smart order routing systems to ensure that their orders are sent to the appropriate marketplace so as not to effect a trade-through. Order routers may be proprietary or built by third party vendors. If a marketplace participant only trades on one marketplace, it will not require such order routers, as its orders will always flow to only one marketplace. However, for those marketplace participants that choose to trade on more than one marketplace that are in competition, or if the trade-through obligation is imposed with respect to all marketplaces (and therefore the marketplace participant is required to regard all competitive marketplaces before trading), sophisticated order routing services will be required.

If the obligation is imposed on the marketplaces, the most efficient way to ensure that price protection occurs is to have the marketplaces electronically linked. The link could enable each marketplace to send its data to other marketplaces. The receiving marketplace would check its incoming orders against the data feed to ensure that a better-priced order on the other marketplace would not be traded-through if it allows the order to be executed on itself. If the marketplace determines that a trade-through would occur if it allowed the order to be executed, it could either route the order to the marketplace with the better-priced order, or it could reject the order back to the marketplace participant. Alternatively, each marketplace could send its order flow to other relevant marketplaces to check for better-priced orders.

12. *Does the absence of a data consolidator affect whether and how the trade-through obligation should be imposed?*

No. The absence of a data consolidator should not affect how the trade-through obligation should be imposed. The pre-trade and post-trade information transparency requirements set out in National Instrument 21-101 should apply regardless of how trade-throughs are governed. The data reporting requirements as they currently exist will continue to be effective. TSX Group is actively working with other marketplaces to distribute data. Our expertise in data distribution has grown, and transparency to the

Canadian market has increased, despite the absence of a CSA mandated data consolidator. We continue to believe that entities such as ourselves can excel at bringing information to the market, and will continue to innovate as we compete within market forces.

13. *Does a regime imposing a trade-through obligation need to address access fees?*

If the obligation is placed on marketplace participants to honour better-priced orders on all Canadian marketplaces, the issue of access fees needs to be addressed only in the event that marketplace participants are also required to honour orders placed on marketplaces that they are not directly connected to. For example, if a marketplace participant is forced to link to a marketplace that it would otherwise not trade on in order to fulfill its trade-through obligation, the marketplace participant should not be penalized by having to pay additional access fees.

If the obligation falls on marketplaces, the issue of access fees must be addressed if the marketplaces are not only required to prevent trade-throughs from occurring, but are also required to ensure that the trade is executed on the better-priced market. Unusually high access fees charged by one marketplace to another would act as a barrier to entry under this scenario.

14. *If a trade-through obligation is placed on the marketplace participants, what other access issues need to be addressed?*

We do not believe that there are any other access issues to be addressed under this scenario.

15. *If a trade-through obligation is imposed, should the obligation use a full depth-of-book approach or only a top-of-book approach?*

The trade-through obligation must honour the full depth of book on a marketplace. This is consistent with the best-price obligation that is currently imposed on participants trading on behalf of clients, as set out in UMIR, and we believe this is reflective of the overall obligation that is owed to the market by all marketplace participants. An order on a transparent marketplace that adds to the price discovery process should be rewarded and should not be traded-through. This is consistent with how block orders are traded today on Toronto Stock Exchange (i.e. dealers that execute a pre-arranged trade or intentional cross must first honour all better-priced orders that are in the central limit order book). As well, the wide-distribution rules of Toronto Stock Exchange allow all better-priced orders in the book to participate in the distribution.

16. *Should the solution developed to deal with trade-throughs include the ability to route sweep orders?*

Sweep technology could be included in the technological solution. This will need to be addressed as the connections are built, and the requirements would be different depending on whether the marketplace participant or the marketplace itself is charged with executing the trade-through obligation.

17. *Where marketplace participants are trading on a marketplace where they do not know if their orders will match and the order book is not transparent, upon execution of an order outside the bid/ask spread of another marketplace, should the participant have to satisfy better-priced orders available on other marketplaces? If so, how? Should this be restricted to visible orders?*

If the responsibility for ensuring compliance with the trade-through obligation falls to marketplace participants, the marketplace participants must honour only better-priced orders that are visible. If a marketplace participant is trading on a marketplace where orders are not visible, the marketplace participant should be obliged to satisfy better-priced orders on other marketplaces immediately after it knows that its order was filled on the non-visible marketplace.

If the responsibility for ensuring compliance with the trade-through obligation falls on the marketplaces, the obligation to honour better-priced orders must be restricted to all visible orders. Non-visible orders do not add value to the price discovery process, and should not have protected standing in the market. However, marketplaces without pre-trade information transparency must be required to execute against better-priced orders on other marketplaces before executing orders on its own marketplace at an inferior price.

The trade-through obligation should not apply if the marketplace participant is entering an order on a marketplace where the price cannot be known upon order entry. This exception, however, should not extend to orders whose price is directly pegged to order prices exposed on the central order book of a marketplace.

18. *If a trade-through obligation is imposed, should it occur at, simultaneously to or immediately after execution of the inferior- priced trade? Should the model accommodate all three solutions?*

The model must be different depending on where the responsibility for compliance with the obligation lies. If the responsibility is on the marketplace participant, the requirement to check better-priced orders must be at the time the order is entered, except in the case, discussed above, where the book is blind and the marketplace participant does not know that its order will be matched. In this case, the obligation occurs immediately after the marketplace participant knows that its order was filled at on the non-visible marketplace. If the responsibility lies with the marketplace, the trade-through obligation should occur at the time of execution of the inferior order.

19. *If a trade-through obligation is imposed, should it apply to all better-priced orders existing when the obligation is discharged, all better-priced pre-existing orders (at the time of execution) or should it be limited to amount of the trade at the inferior price?*

The trade-through obligation should apply to all better-priced orders existing when the obligation is discharged.

20. *If a trade-through obligation is imposed, should exemptions be provided for special terms orders? Which ones and why?*

Certain special terms orders should be exempt from the trade-through obligation. Generally, special terms orders that do not impact the last sale price and do not execute in the central order book (such as orders with special settlement terms like delayed delivery) should not be honoured as better-priced orders. Similarly, they should be exempt from the better-price requirement. That is, they should be permitted to trade-through better-priced orders.

There could be other bona fide reasons why certain special terms orders are executed outside of the central order book. For example, a non-resident purchasing a security with foreign ownership restrictions may need to pay a premium in order to purchase the security from another non-resident. As he would be unable to purchase better-priced orders from a resident Canadian selling shareholder, the non-resident must be permitted to purchase at a premium to the market, if that is all that is offered by a non-resident seller. This type of scenario holds true for other special terms orders as well. If a purchaser is unable to take delivery of a security for an extended period of time, the market may have moved away from the order price during the time that it was waiting to be executed against. If the order was entered with special settlement terms attached, and at the time of execution trades outside the spread, it should not be required to honour better-priced orders on other marketplaces. This exemption must only be applied to true special terms orders. For example, a marketplace participant who enters an order with a T+4 settlement date to intentionally circumvent its trade-through obligation should not be permitted to trade-through.

On the other hand, special terms orders that can be used to establish the last sale price because they are executed in the central order book should not be exempt from the obligation to trade first against better-priced orders. For example, an order for less than a standard trading unit on Toronto Stock Exchange will execute in the central limit order book and must honour better-priced orders on other marketplaces. This is also true for special terms orders where a trading term (rather than a settlement term) is the condition that qualifies it as a special terms order, such as an “all or none” order. Despite the fact that these special terms orders that execute in the central order book must honour better-priced orders, they themselves will not be protected if they are not displayed in a visible book.

21. *If a trade-through obligation is imposed, should an exemption be provided for orders for which the price or other material terms cannot be determined on order entry?*

As discussed under question 17 and discussed in the letter, an exemption must be provided for orders where the price or other material terms cannot be determined on order entry. This is different from the obligation when trading on blind marketplaces that continuously match order flow, as the marketplace participant knows its order’s price at the time of entry, but just doesn’t know if the order will be filled.

22. *If a trade-through obligation is imposed, should it include an exemption for large block trades?*

Large block trades should be subject to the same trade-through obligation as small orders.

23. *Should the size threshold for a block trade exemption for the same security traded on multiple marketplaces be the same across marketplaces? If not, what would the impact be?*

As stated in our response to question 22, there should not be any trade-through exemption for block trades.

24. *If a trade-through obligation is imposed, will sweep orders facilitate the execution of block orders? How?*

Sweep orders could facilitate the execution of block orders.

25. *If a trade-through obligation is imposed, should it apply to any non-visible portions of a trading book?*

As stated in our response to question 17 and discussed in the letter, the obligation, whether imposed on a marketplace or a marketplace participant, should not apply to non-visible orders.

26. *Should we provide the ability to opt out of routing orders to marketplaces where the better-priced order is on a manual marketplace or should the rule be drafted to apply to protect only those orders that are immediate and automatically accessible?*

The trade-through protection rule, regardless of whether the responsibility for ensuring compliance with the trade-through obligation will be imposed on the marketplace participant or on the marketplace, should be applicable only to immediate and automatically accessible markets.

27. *What is the impact of imposing a trade-through obligation on non-dealers?*

If the responsibility for ensuring compliance with the trade-through obligation is imposed on marketplace participants, the regulators (CSA, RS) would need to clarify whose jurisdiction, and therefore rules, the non-dealer participant would be subject to. This jurisdiction would either be established by contract or under statute. The applicable regulator would need to ensure that it would be in a position to adequately enforce against such parties in the event of a violation of the trade-through violation.

28. *Does the introduction of multiple marketplaces trading the same security cause a conflict between what is needed to meet best price obligations and what is needed to meet best execution obligations if the latter is defined as something different from best price only? How can this conflict be resolved? Is one obligation, best price or best execution more important than the other? Why? Why not?*

Best price is a part of best execution, which is an obligation owed by a marketplace participant to its client. Best price is an important component of best execution. Distinct from best execution, the obligation to ensure that better-priced orders are not traded-through is a duty owed by all marketplace participants to the market as a whole.

29. *How should locked or crossed markets be treated? Should procedures be set up to limit the occurrence of locked or crossed markets? If so, upon whom should the obligation be placed?*

The issue of locked and crossed markets will be very different depending on whether the responsibility for ensuring compliance with the trade-through obligation is imposed on marketplaces or marketplace participants. Multiple factors will need to be considered once this determination has been made.

30. *Should the method of trade allocation (price priority or price-time priority or some entirely different method) be the same for all marketplaces or should the marketplace be allowed to determine its own procedures for allocation of trades? Why or why not?*

As is currently the case, we believe that each marketplace should be allowed to determine its own procedures for allocation of trades. The threshold requirement must be that visible better-priced orders on the Canadian marketplace are not traded-through. After that basic requirement is met and certain exceptions enumerated, each marketplace should be able to determine its internal allocation procedures. We believe that price-time priority is beneficial to the marketplace because it rewards orders that are entered early, but we do not believe that every marketplace should be required to establish this procedure if they do not agree with this approach.

31. *Should the last sale price reflect trading on all marketplaces or should each marketplace have a separate last sale price? Why or why not?*

We believe that each marketplace should have its own last sale price. However, given that certain important UMIR requirements (such as short sale rules and market stabilization rules) are based on the last sale price, marketplace participants made need to take into account more than one last sale price in order to comply with UMIR.