BMO Nesbitt Burns

September 19, 2005

British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Financial Services Commission
Manitoba Securities Commission
Ontario Securities Commission
Autorite des marches financiers
New Brunswick Securities Commission
Registrar of Securities, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Registrar of Securities, Northwest Territories
Registrar of Securities, Yukon Territory
Registrar of Securities, Nunavut

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Re: <u>CSA Discussion Paper 23-403 – Market Structure Developments and Trade-Through Obligations</u>
And
<u>RS MIN 2005-016 – Interim Provisions Respecting Trade-Through Obligations</u>

BMO Financial Group is pleased to have the opportunity to provide its comments on the Canadian Securities Administrators' Discussion Paper 23-403, "Market Structure Developments and Trade-Through Obligations." These comments will also serve as our response to Regulation Services Inc.'s request for comments on Market Integrity Notice 2005-016, "Interim Provisions Respecting Trade-Through Obligations."

BMO Financial Group requests permission to participate in the CSA Public Forum on Friday, October 14, 2005.

We are fully supportive of a Canadian market structure that supports trade-through obligations. A fair and orderly market is one in which the best-priced orders will trade first. A level playing field in the competition for order execution is key to maintaining confidence in the Canadian markets.

We are also supportive of a review of market structure developments that pertain to many interlinked aspects: best execution, straight through processing, TREATS, data consolidation, and trade-through obligations. None of these can be viewed in isolation. It is of paramount importance that solutions to each lead to a consistent and cohesive whole. When UMIR was originally developed, alternative trading systems (ATSs) in Canada were merely a concept; now they are a reality.

The reality has brought with it the realization that there are regulatory gaps that must be addressed. Direct market access has blurred the distinction between Participant and Access Person and broadened the focus for regulatory scrutiny. We strongly recommend that any solution that is adopted be forward looking, contemplating not just the current state, but potential future states. For example, to date Canadian markets have been electronic, so accommodation for manual markets was not required. However, on a forward looking basis, the possibility of a manual market should be contemplated, and the rules drafted to apply to protect only those orders that are immediately and automatically accessible.

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. Except for the third point, we are in agreement with these factors. We do not agree that "displayed depth" need be a requirement for the Canadian market structure. The popularity of "iceberg orders" belies this, indicating that shielding the visibility of large orders can be a component at times in the strategy of achieving best execution.

We also do not agree with the CSA assertion of "best price obligation (which is the current definition of best execution)." Best execution has not been defined as achieving the best price. UMIR 5.1, Best Execution of Client Orders, requires a Participant to "diligently pursue the execution of each client order on the most advantageous terms for the client as expeditiously as practicable under prevailing market conditions." Price is only one component of a transaction. Best price and best execution are independent concepts. Depending on the dealer, the client, the security, and the marketplace, achieving best price may be totally consistent with achieving best execution or it may be an ancillary consideration, dominated instead by speed of execution, certainty of execution, total transaction cost, the client's instructions, liquidity, order size, or settlement considerations.

Discussions of the structure of the Canadian market should include the context of other North American markets and international markets, but recognize where we are divergent and unique. The discussion must focus on the complexity of implementation among disparate participants, markets, and systems versus the costs and benefits of proposed regulatory changes.

Trade-through protection should be imposed where there are multiple marketplaces trading the same securities. To do otherwise is to invite arbitrage of the investors who provide liquidity to the marketplace by placing limit orders. As noted above, this will undermine confidence in the Canadian market.

All marketplace participants owe a general duty to the market and thus should be subject to trade-through obligations. We believe that this will be best implemented if it is imposed on the marketplace rather than on marketplace participants. Anything less invites regulatory arbitrage. A participant might reasonably claim that their obligation is limited to their access to particular marketplaces; a full service dealer would have no choice but to subscribe to every new marketplace to fulfil their obligations to their clients. This could result in artificial "success" in the early stages for new marketplaces. Interconnected Canadian marketplaces would also avoid the perennial problem of the lack of a Canadian data consolidator. As well, immediate and automatic linkages would serve to "sweep" the market of any better-priced orders.

Given the relatively small number of marketplaces at this stage of the Canadian market's evolution, marketplace linkages are the most rational choice. While this may impact innovation and competition in the Canadian market, by raising the cost of entry, for example, additional regulatory structure is not necessarily negative. Innovative energy can then be directed to advancing more creative product offerings.

The access fees imposed by the marketplaces should not be part of the regulation, as these will form part of the product offering by the marketplace and are thus a business decision.

We recommend that a Canadian trade-through obligation should use a full visible depth-of-book approach. This differs from U.S. Regulation NMS, which is a top-of-book approach, but is consistent with recommendations that BMO Financial Group submitted in response to RS's Provisions Respecting "Off-Marketplace" Trades. The undisplayed portion of iceberg orders should not be included in the depth-of-book determination. The trade-through obligation should be limited to those orders visible on the marketplaces at the time of execution.

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, the executing marketplace, not the participant, should be required to satisfy visible better-priced orders available on other marketplaces. The marketplace linkages should satisfy this requirement. If there is a minimum transaction size on a marketplace (for example, 25,000 shares) those orders should be treated as contingent orders, and subject to exemption from the trade-through obligation unless the order to be executed at the inferior price exceeds the minimum.

Optimally, a trade-through obligation will be satisfied in the following way: all visible better-priced orders will be executed; then the balance of the order will be executed at the inferior price. The marketplace with the inferior order that is responsible for "sweeping" the better priced orders elsewhere must execute them simultaneously. Best execution will not be served if latency is introduced via the sweep process that results in the inferior order trading away while the sweep is taking place elsewhere.

The trade-through obligation should be limited to the original volume of the trade. A trade-through obligation that applies to all better-priced orders existing when the obligation is discharged would introduce unwarranted risk into the market, creating an incalculable potential liability. The obligation should never exceed the originally intended volume of the transaction. A regulatory regime that would require honouring all existing better-priced orders in addition to the inferior priced order would be inappropriate.

Exemptions from the trade-through obligation should apply to special terms orders. Orders with special settlement terms or minimum thresholds in excess of standard board lots should be exempt. Exemptions should apply to orders for which the price or other material terms cannot be determined on order entry. Thus market on close, opening, vwap, basis, call market, contingent, and basket orders should be exempt. For the same reasons, it is appropriate to treat trade-throughs differently on derivatives markets than on equity markets. Derivatives markets facilitate more complex transactions, the bulk of which are contingent and hence the price of an individual leg of the transaction cannot be determined on order entry. Given the

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unique and ever-changing nature of the derivatives markets, the regulators should remain open to the possibility of further requests for exemptions.

Large block trades should be subject to the trade-through obligation only to the extent of the visible depth of book for better-priced orders. No obligation should be owed to the hidden part of iceberg orders. For any block trade exemption, the size threshold for the same security traded on multiple marketplaces should be the same across marketplaces to avoid regulatory arbitrage.

If a trade-through obligation is imposed, "sweep" orders, executed through interlinked marketplaces will help facilitate the execution of block orders by reducing errors and the number of steps required to execute the block trade.

Imposing trade-through obligations on marketplaces, and the resulting linkages that will be established will naturally reduce locked or crossed markets. Coupled with normal market forces, there is no need to establish regulatory procedures for dealing with locked or crossed markets.

The method of trade allocation (price priority or price-time priority or some entirely different method) should be at the discretion of the marketplace. Each marketplace should be allowed to determine its own procedures for allocation of trades as part of its unique product offering. It is a business decision that may prove to be a source of innovation, as long as the allocation methodology is consistent with any trade-through obligations. We recommend, however, that last sale price should be determined by the primary exchange.

If you have any further questions, please do not hesitate to contact us.

Regards,

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