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

c/o John Stevenson, Secretary
Ontario Securities Commission
Queen Street West
Suite 1903, Box 55
Toronto, Ontario M5H 3S8

Re: Discussion Paper 23-403 – *MARKET STRUCTURE DEVELOPMENTS AND TRADE THROUGH OBLIGATIONS*

Dear Mr. Stevenson,

RBC Capital Markets is pleased to respond to your request for comments regarding Market Structure Developments and Trade-through Obligations. Evolving market developments necessitates this discussion and we applaud the CSA for undertaking this review of the issues.

As well as providing this written response to your specific questions, we would like to participate in the public forum scheduled for October 14, 2005.

In general we are in favour of trade-through protection, believing that prevention of trade-throughs is an obligation that all marketplace participants owe to the market. However, it may be impractical as well as prohibitively expensive to extend the obligation to market place participants that currently are not required to honour this obligation. Rather a more practical solution would be to extend the trade-through obligation to the marketplaces.

We provide answers to your questions below.

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

In addition to the four objectives identified in the discussion paper, other factors or criteria include; (i) the need to ensure fairness to all marketplace participants – are regulations going to be created (or not) that place some marketplace participants or indeed marketplaces at a competitive advantage or disadvantage as the case may be, (ii) does the total cost of compliance with regulation outweigh the benefit that regulation provides to the market in general, (iii) is regulation (or the lack of) going to encourage some marketplace participants to conduct business in a manner that **arguably** might not be in there own or their clients best interest.

2. What market structure issues should be considered as part of the discussion on the tradethrough obligation?

We believe that the specific market structure issues will be adequately addressed in the bulk of our response to the question posed by the CSA.

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 do not believe that the scope of this discussion should be broadened. Although it might be a worthwhile exercise to have that discussion at some point in the future, we believe that a discussion that focuses more specifically upon the unique issues surrounding exchange traded securities is more likely to arrive at an optimal solution to the problems/trade-offs identified in the discussion paper.

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

We agree wholeheartedly with RS's rationale for the trade-through obligation. Simply put, if there is no benefit to disclosing trading intention through a limit order, why would a rational individual do so? We believe that the consequences of investors behaving rationally in a no trade-through environment is as RS states; "market quality declines for all investors."

As well, we agree that the trade-through obligation has been historically viewed as an obligation to the market rather than as a fiduciary obligation to the client. Further, if others argue that this has not been the case historically, we would suggest that the obligation should be to the market based upon the rationale for the trade-through obligation mentioned above. We therefore agree that an access person should not be able to opt-out of this obligation to the market.

We do agree in principle with the need to extend the trade-through obligation to Access Persons and indeed to direct access clients of participants. This follows directly from our view that the trade-through obligation is owed to the market. However, we further believe that the "cost" (required systems, increased personnel to monitor markets, internal audit requirements) of complying with the obligation may be prohibitive for many Access Persons and indeed the cost to the regulator of ensuring compliance may also be excessive. Further it is possible that unintended consequences could result from extending the trade–through obligation to Access Persons. For example, a perverse solution to the requirement to guard against trade-throughs would be to cut-off or not subscribe for access to a particular marketplace.

We agree with the excluded orders that RS lists and also agree with their rationale for doing so in each particular instance.

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

As stated in the discussion paper, Canada does not have as many marketplaces. Further it is reasonable to assume that Canada will not have as many marketplaces for the foreseeable future. As stated in the paper, inter-market trade-through protection may be a less complex problem to resolve in Canada versus the US.

As well, Canada does not currently have any manual markets. It is possible that manual markets could start up in the future, however, given trends in the industry, we find that unlikely. The absence of a manual market in Canada implies that the issue of fast markets versus slow markets does not have to be dealt with in Canada.

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

By their very nature, derivatives are different from cash market securities. By definition, their value is derived from some other security or securities. Therefore price discovery in derivative markets is not exclusively a process of bids and offers competing in a continuous auction process as is the case in cash markets (whether on an exchange or OTC).

Limit orders in derivative markets will get filled when they are fairly priced or certainly when they are slightly misspriced. This would occur even in an environment in which trade-throughs are allowed.

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?

Yes. Preservation of the price discovery process and maintenance of investor confidence in the market is paramount. We agree with the argument that allowing trade-throughs robs marketplace participants of the incentive to expose limit orders and therefore allowing trade-throughs may impair liquidity and reduce confidence in the market.

While certain investors may be sophisticated enough to decide the factors that go into the decision to trade, they nonetheless owe a duty to the market itself. They and/or their clients derive a benefit from the price discovery mechanism and they should be compelled to help preserve that price discovery mechanism.

However, we have argued earlier in this response that it may be prohibitively expensive for Access Persons to have to monitor and comply with a trade-through obligation. If this is the case, it becomes necessary to impose the obligation on the marketplaces themselves (while not ignoring the fact that the obligation still resides with Access Persons).

Although imposing the trade-through obligation on the marketplaces would imply an expense to those marketplaces, we would argue that this is simply a cost of meeting the regulatory responsibility to the Canadian Market.

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

If the trade-through obligation is extended to marketplaces as we've argued, we do not believe that this would impact competition and innovation.

It is very easy to envisage numerous and varied business models that could be implemented that wouldn't be impacted by the need to preserve trade-through protection. Yes, linkages would have to be established and rules would have to be followed but we can't see how in and of itself, that would impact innovation.

Granted, it would raise the cost of doing business somewhat, however, as we've already stated in this response this is a necessary cost of doing business.

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 have argued above that all marketplace participants owe a general duty to the market.

If we believed that trade-through protection arose only due to the fiduciary obligation of an intermediary (a dealer) to their client, it follows that in the case of numerous clients of the intermediary, the intermediary may have a fiduciary duty to trade-through given that the client could argue that trading objectives may be better satisfied by trading through. It further follows that trade-through protection should therefore only be extended to situations were best price was the paramount consideration in the decision to trade. Simply put, we don't buy that argument.

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

All marketplace participants owe a duty to the market. Therefore marketplace participants should not be absolved of the duty to ensure that they do not trade-through.

However, practical considerations, as argued in the discussion paper, necessitates the need to impose the trade-through obligation on the marketplaces. (As an aside, we do believe that some from of proficiency requirement for Access Persons and direct access clients should be investigated). As we've stated above, we do not believe that innovation will be stifled in this circumstance.

Given that the price discovery process and confidence in the market **must** be preserved, it follows that someone has to bear the cost of doing so.

When considering the summation of all costs to market participants and marketplaces, it is clear that the most efficient and therefore least costly alternative is to impose the trade-through obligation on the marketplaces.

Presumably, this cost of doing business can be recovered through the fees that are charged by the individual marketplace.

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 trade-through obligation is imposed on marketplaces, linkages between those marketplaces or a centralized "hub" would need to be established. Existing order routing technology could conceivably be purchased and modified to satisfy the need to route to other marketplaces to fill better priced orders. At a high level (ignoring for the moment the "when and what" considerations of satisfying trade-through obligations) the solution is fairly simple, although there is a cost associated with this solution.

In the case of marketplace participants there are broadly speaking three solutions available to them should the trade-through obligation be imposed upon them in an environment where marketplaces do not have that obligation.

The first "solution" is to ensure that they do not have access to multiple marketplaces. In and of itself, this solution, if widely adopted would suppress innovation and create what amounts to a regulatory impediment to the establishment of new and innovative marketplaces. As well, it is possible to argue that these market place participants may not be able to achieve "best execution" objectives in this type of an environment. Although what constitutes "best execution" has yet (may never?) be clearly defined in rules and regulations, institutional investors and their institutional clients are taking the issue more and more seriously.

The second solution is to hire more individuals to monitor markets and ensure that the trade-through obligation is satisfied. Faced with the choice of incurring additional cost or picking solution 1, we'd venture to say that many organizations may choose solution 1.

The third solution is to purchase or develop the smart order routing technology that would be capable of monitoring a number of market places and routing orders to satisfy the trade-through obligation. The cost of implementing this type of technology at numerous businesses that qualify as access persons would be extremely large and would almost certainly be far more expensive in total than the technological solutions required should the obligation be imposed on marketplaces. Given the cost, we would suggest that many Access Persons would opt for solution 1.

An alternative to the third solution is to contract out the technological requirements. Generally speaking this would imply routing to a dealer's smart order router. The downside of this approach is the fact that control over the choice of trading venue would at the very least be eroded.

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

If a data consolidator existed, it could conceivably reduce the cost of imposing a trade-through obligation on either marketplace participants or marketplaces. If a business case could be made for expanding the role of the data consolidator into a "hub" that provided linkages to those that required them and further, routed orders to "best price" venues then the market in general might in fact derive a benefit from the existence of this data consolidator hub type structure. This of course ignores business considerations such as who would pay for it etc.

The fact that the cost would be reduced in either case of imposing an obligation on marketplaces or on marketplace participants is irrelevant. The cost of imposing the obligation on the marketplaces would still remain far lower.

Would the existence of a data consolidator eliminate the need for the trade-through obligation? We don't think so. Many will argue that a data consolidator would provide easy access to information regarding where best price orders reside. Therefore, marketplace participants would automatically route to the venue with the best price in the absence of other reasons or criteria for executing a trade. In principle this would be correct if all market place participants could route to all venues. Due to the cost of doing so, we do not believe that marketplace participants would implement the technology to take advantage of more easily accessible information.

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

We don't believe so. Competition should be sufficient to impose discipline.

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

We believe we have addressed this question in answers to earlier questions.

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?

Given our earlier argument with regard to the need to preserve the price discovery process and the need to ensure confidence in the market, it follows that the historical protection of the full depth of book(s) in Canada should be maintained.

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

The ability to route sweep orders may simplify the process of complying with trade-through obligations in some cases. This solution would only be applicable to situations in which the sweep order is routed to marketplaces that maintain transparent quotes due to the timing issues regarding when and if a trade occurs in the ultimate destination marketplace. An example of a situation where a sweep wouldn't work follows. A sweep order could be routed to marketplace x. Marketplace x does not maintain transparent quotes and therefore there is no way to know when or even if this order will be matched and executed. The sweep order filled a number of better priced orders on its way to marketplace x. As the order sits in marketplace x better bids or offers emerge in other marketplaces. Finally a match within marketplace x occurs. We believe that at this point in time, better price orders would need to be filled and therefore the sweep order would not have accomplished the goal of satisfy 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?

The participant should have to satisfy only visible orders on other marketplaces. This should be accomplished by utilizing the linkages/mechanisms put in place by the marketplace due to their requirement to ensure that trade-throughs do not occur. It almost becomes a requirement in this situation that the potential execution at the inferior price not occur until visible demand at better prices is satisfied in whole or in part. This could be accomplished by the marketplace first executing a sweep order on behalf of the participant. Volume would be known prior to the execution of the sweep as a "snapshot" of all visible orders would be taken at the time. Of course contingencies placed upon the other side of the match may complicate the necessary algorithm that determines whether a match occurs (ie. A minimum volume requirement) however, we believe that these are complications in the process rather than impediments to the process.

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?

We believe that the goal should be to impose the trade-through obligation simultaneously to the execution of the inferior priced trades. Of course this may not be an operationally attainable goal.

Our answer to question 17 indicates our recommended approach. We prefer the snapshot approach. This would require that all marketplaces had synchronized clocks and that the time stamp associated with the sweep order would become a necessary determinant of whether or not a better priced order is filled.

We believe that the trade-through obligation cannot be imposed immediately after execution since we believe that the trade-through obligation should be limited to the original amount of the trade and further it is possible that the volume of better priced orders will change in the small amount of time that elapses. It would therefore become necessary to bust all or part of the original inferior trade amount in order to satisfy the increased/decreased demand at better prices.

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?

We believe that the trade-through obligation should be limited to the amount of the potential trade at the inferior price. Under our preferred methodology outlined above, it is possible to envision a situation in which a potential match occurs, the necessary sweep order is launched and one side of the potential match is completely satisfied by the sweep implying that a match doesn't in fact occur. This might be considered as something of a perverse result given that the absence of a match would imply that the sweep order would not be launched at all.

We believe that competitive considerations would ensure that this type of perverse result would not occur.

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

Yes, As we indicted earlier in this response we agree with RS in the types of orders that they would exclude from trade-through obligations and the rationale for excluding those types of orders.

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?

Yes. Please see answer to question 20 above.

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

No. It should not (and has not in the past) be difficult to displace smaller visible orders in the book or books. We emphasize that the amount displaced should be limited to visible orders in the book or books at the time that the snap shot is taken. Further we emphasize that an exemption should not be extended for single order large block trades.

It may be beyond the scope of this discussion, however, we would like to discuss trading of baskets of securities. Market practice in the case of a principal basket has been to price the entire basket of securities on a net basis including a mark up or mark down. Some have argued that this may constitute a trade-through. We disagree. We believe that the mark up/down represents a risk premium applied that is appropriate in its application when a dealer is putting its capital at risk on a large trade. Our earlier argument regarding derivatives applies. The value of the basket is derived completely from the underlying constituents of the basket and therefore in and of itself does not contribute to the price discovery process. It is quite possible that the individual trades would not occur in an environment were the initiator of the trade had to bear all of the execution risk of trading that basket. If this is the case, it could not be argued that the individual constituents of the basket would need to be exposed to some marketplace therefore contributing to the price discovery process.

Further, in the CSA's concept paper 23-402, the CSA stated that they had a difficult time understanding why both commissions and mark ups could appear on a trade ticket. We would argue that these are charges that apply for different services and it is sometimes appropriate to include both. The mark up/down represents a risk premium while commission can represent payment for execution, research etc.

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?

We do not believe that single order large block trades should be exempt from the trade-through obligation.

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

The model that we have described that includes sweep orders launched by the marketplaces would facilitate the execution of block orders. An example may be illustrative.

A dealer has brokered a deal between two parties to execute a block of 100,000 shares of XYZ Corp. The agreed to price is at a 1% discount to the best bid in all marketplaces. The parties agree that the trade will be posted on the TSX. The cross is entered into the

TSX trading engine however, at this point all that is implied is that a match has occurred between a buyer and a seller. A snapshot of all visible orders in all marketplaces is taken. It is determined that the total volume of better priced orders is 1,400 shares including those in the TSX's own book. The TSX launches a sweep order on behalf of the seller that displaces all better priced orders including those in its own book. The residual volume of 98,600 shares is posted to the exchange.

In effect the current methodology could be utilized as well. This assumes that the dealer in question has access to all marketplaces that include visible books. All 1,400 better priced orders could individually be displaced, the residual cross could be posted and a sweep (of nothing) would be launched. There is risk in the latter approach however, as other marketplace participants could enter orders prior to the cross that would interfere with the block being posted.

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

Non visible orders do not contribute to the price discovery process and therefore there should be no obligation to fill better priced non-disclosed 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 rule should be drafted to protect only those orders that are immediately and automatically accessible. Delays in execution caused by quotes in manual markets that may or may not be there are unacceptable.

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

As we have stated earlier in this response, we believe that a trade-through obligation should be placed upon marketplaces as well as upon non-dealer marketplace participants. We have outlined what we believe to be some of the potential consequences and implications of imposing the trade-through obligations on non-dealers if the trade-through obligation is not imposed on marketplaces.

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?

If a functioning efficient model that precludes trade-throughs is implemented, best execution and trade-through obligations are not mutually exclusive concepts. Clearly best execution (at least as a concept in the absence of a prescribed definition or process) is more important. If we utilize the suggested definition from Concept Paper 23-402 "that best execution means the best net result for the client …" it is hard to argue that best price is more important than the best net result. However, we believe that a model that preserves trade-through protection while ensuring that other relevant elements of the trade decision are considered can be implemented. As long as the model does not slow execution, does not reduce the certainty of execution, does not significantly increase the total cost of transacting, does not increase the chance of missing trades, etc. then both goals can be achieved.

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?

Under our model it becomes the responsibility of the marketplace to sweep for better priced visible orders if a potential trade match occurs. This implies a crossed market could conceivably exist for a brief period of time but trades would never be executed at inferior prices. For example, if there is a visible offering on marketplace A that is at a lower prior than a bid on the TSX and someone attempts to hit that bid, this would trigger a sweep and at least a portion of that bid would execute against the lower priced offering on marketplace A.

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?

Save for the requirement to ensure that trade-throughs do not occur, the method of trade allocation should be a competitive decision that each marketplace makes. If marketplace participants don't like the method they won't use the marketplace.

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?

The last sale price is in theory a representation of the prevailing market value of the security. The last sale price should reflect trading on all market places.

In conclusion, a simple description of what we are advocating is a model that is very similar to the US model, although we are advocating full depth of book trade-through protection. This model was thoroughly debated in the US for many months prior to the implementation of Reg NMS.

Yours truly,

John Reilly
Managing Director
RBC Capital Markets