MARKETS
ELECTRONIC TRADING SYSTEMS

Canadian Securities Administrators
British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Securities Commission
Ontario Securities Commission
Autorité des marchés 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
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and

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September 19, 2005

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

Dear Sirs/Mesdames:

Markets Securities Inc. ("MSI") welcomes the opportunity to submit its views on the Canadian Securities Administrators' ("CSA") Discussion Paper 23-403 – *Market Structure Developments and Trade-Through Obligations* and commends the CSA for taking the time to conduct a comprehensive and thoughtful analysis of this important and complex issue.

Introduction

MSI currently operates the only alternative trading system in Canada that trades the same securities as the Toronto Stock Exchange ("TSX"). Here is a brief description of our marketplace, which is known as BlockBook™.

- Fully electronic and automated marketplace specializing in block trades
- Minimum order size of 25,000 shares
- Open to buy-side and sell-side members
- No pre-trade order display to minimize price impact
- Limit orders and price discovery through automated negotiation
- Completely anonymous, but full disclosure of executions
- Proprietary, patent pending features

BlockBook is an alternative to the existing, manual, upstairs market. As such, BlockBook offers three key points of value and differentiation to its clients and to the Canadian capital markets as a whole. First, BlockBook is the first and only venue where buy-side and sell-side traders of large blocks can meet in a single pool of liquidity. This offers a substantial consolidating benefit over the existing fragmented structure of the upstairs market where each dealer's block desk operates as a distinct silo of liquidity. Second, because BlockBook operates completely electronically, with automated executions, anonymity and direct access, there is no possibility of the information leakage that is unavoidable when using a human intermediary. Front running is impossible and a complete electronic audit trail is maintained. This translates into lower execution costs, better returns for the ultimate clients and more efficient markets. Third, BlockBook's proprietary negotiation features allow true price discovery and the potential for price improvement which further contributes to an efficient and competitive Canadian capital market.

BlockBook commenced live trading on August 22, 2005. At present we have 19 members of which 15 are buy-side institutions and 4 are dealers. Since inception, our average order size is 93,665 shares and the average execution size is 47,357 shares. This compares to the TSX average execution size of 1,223 shares including blocks and crosses (August 2005). On a value weighted basis, executions on BlockBook have represented 78% of the stocks' Average Daily Volume (ADV) on the TSX. Normally, any order exceeding 20% of the ADV would be expected to create a significant price impact, however, of the 14 executions to date, 9 have occurred within the TSX quote and 5 have occurred outside (although 3 of those 5 were generated from the same order). Interestingly, in each of these cases, the TSX book reacted quickly to the BlockBook execution information and the better priced orders were filled, *even when*

there was no regulatory obligation to do so. Plus, each of these trades was far in excess of the 20% of average daily volume rule of thumb at which point the order size is expected to create significant price impact. While these are still very preliminary findings given the short time period and small sample set, they are worthy of discussion as they are the only "real" evidence we have to validate theories regarding investor behaviours and trade-through protection. We intend to present an updated summary of order and execution history on BlockBook in our public presentation.

As market participants with a long history in various capacities within the Canadian and international capital markets (buy-side, sell side, vendor etc), the management of MSI has strong views on many aspects of the debate surrounding trade-through. We have considered the arguments and understand and agree with the fundamental values those favouring such a rule are trying to protect. However, as a recent entrant and the first truly competitive marketplace, we are in a unique position to offer a different perspective. Accordingly, we will focus our remarks on those aspects about which we have the most direct knowledge; namely competition and innovation.

We believe we can provide value to our clients whether or not a trade-through rule is implemented, and are currently doing so for our dealer clients. However, we are convinced that the extension of the existing rule, as proposed by Market Regulation Services Inc. ("RS") (MIN 2004-018, MIN2005-016, etc), without substantial modification would seriously compromise our ability to retain and attract buy-side clients and would generally hamper new marketplaces from forming. Further, a rule requiring marketplaces to enforce compliance with a trade-through rule is potentially even more damaging to new entrants as a result of the lack of existing smart order routing technologies available in Canada. Therefore we urge the CSA and RS to proceed with extreme caution and an adequate implementation period. The most difficult task given the newness of alternative markets in Canada will be to ensure that there is clarity and hard evidence regarding the "harm" any rule is intended to address and that the benefits clearly outweigh the costs, both explicit and otherwise, including the cost to competition and innovation.

Finally, we acknowledge the concerns regarding a "level playing field" of the existing rule, whereby institutions (Access Persons), when accessing a marketplace directly, do not have the same displacement obligations as when using a dealer as intermediary. This discrepancy reinforces our view that the current rule only makes sense in the context of the Best Price Rule, or as a back-stop to the dealer's obligation of best execution. That is, a part of the dealer's duty to the client and not as part of a general duty to the market. If the CSA maintains the current purpose of the rule, we would suggest that offering sophisticated clients the ability to "opt-out" of this protection

when using a dealer would be a simpler and more effective way to rectify this regulatory imbalance.

If, on the other hand, the CSA decides to re-characterize the trade-through rule as an obligation to the market generally, we strongly oppose the simplistic extension of the existing rules to all investors, as proposed RS. Rather, we urge the CSA to craft a realistic rule from first principles which adequately considers the special constraints of institutional investors and finds a way to temper the concomitant anti-competitive side-effects.

This letter is our preliminary response to the request for comments and will form the basis of our presentation, should we be invited to the public forum on October 14, 2005. In addition, we are preparing a full response to the questions in the discussion paper to be submitted by the October 20th deadline.

Background

Trade-throughs are a natural by-product of multiple marketplaces. Some are intentional and some are not. Intentional trade-throughs can result from deficiencies in particular marketplaces. For example, an investor may intentionally route an order to Marketplace A, notwithstanding the presence of better-priced orders on Marketplace B, as a result of some disagreement with Marketplace A's operation. This phenomenon was seen clearly in the US experience. As new marketplaces proliferated in the 1990s and different matching mechanisms were available, investors consciously routed orders away from NYSE as a result of dissatisfaction with the specialist system. If investors had been constrained in their choice of marketplace to the best posted price, the ability of the marketplace innovators to gain market share would have been severely impeded and the competitive forces driving the current changes at the NYSE would have been weaker.

Another common circumstance which gives rise to intentional trade-throughs is where the terms of the desired trade do not match with the standard terms of the marketplace with the displayed better-priced order. As a result, the pricing of those non-standard trades incorporates factors which are not present in the more standard orders.

For example, an order with constraints, such as a short settlement period, would not match with a standard settlement order and the contra side may demand a premium or discount to accommodate this special requirement. Other examples include orders which are contingent on other orders (pairs trading or basket trades), orders priced by an external benchmark (e.g. VWAP), orders with minimum fill constraints or orders requiring a complete fill in excess of the lot size (e.g. all-or-none). These "justifiable"

trade-throughs are already recognized by the CSA as Special Terms orders which, to date, have been exempted from the application of any trade-through obligations.

We would argue that orders of a size which could be reasonably expected to affect the market price of a security if they were known in advance (i.e. block trades) should also fall into this same legitimate trade-through category. Orders of this magnitude will never be displayed (as a result of the potential negative price impact) and may naturally require a premium or discount to the displayed market price. In all areas of commerce, whether for toothbrushes or interest rates, the price differentiation between wholesale and retail size is readily accepted. This is an economic fact that should also be respected in the public equity markets.

Unintentional trade-throughs, on the other hand, result from the irrefutable fact that, notwithstanding all the efforts and rules to prevent it, it is impossible to prevent the orders on one marketplace from changing at the same time an execution occurs on another marketplace (assuming the marketplace engages in price discovery and is not just a crossing mechanism using another marketplace's prices). This type of trade-through is typically of small magnitude (e.g. 1 -3 cents) and of short duration as the markets will naturally incorporate the execution information and adjust, either by altering the prices of the standing order(s) or through trades occurring which take out the better priced orders. These occurrences can be reduced through regulatory requirements for linkages and market integration; however, they can never be eliminated entirely.

The benefits of trade-though reduction and the constraints which would be reasonable to impose on the market are inextricably linked. If one believes that any trade-through, no matter how small or how brief, presents an irreparable assault on the integrity of the capital markets as a whole, there is ample justification for the most onerous regimes of trade-through reduction. The logical conclusion of this position is the support for one central limit order book. The resulting implication for competition among marketplaces is obvious: there will be no effective competition; the lowest common denominator will be served; and existing markets will be entrenched without incentive to change or innovate.

If, on the other hand, one believes, as we do, that most trade-throughs are the logical representation of the vibrancy of multiple price discovery mechanisms, there is a real cost to the imposition of regulatory restrictions. This cost is fundamentally one of reduced investor choice. The regulatory challenge given the CSA's continued commitment to fostering competitive marketplaces, therefore, is to identify and constrain only those circumstances that clearly represent a real risk to the market without impeding legitimate trading activities.

Costs of Trade-Through Protection

We believe that the imposition of a comprehensive anti-trade-through regime, such as proposed by RS, would hamper the development of competition and innovation in the Canadian markets. The cost of any regime designed to minimize trade-throughs is substantial; both in real dollars and in the resulting constraints on investor choice.

Hard Costs

The real dollar cost of the system development required to ensure compliance with anti-trade-through rules is substantial. This is true whether the obligation is placed on the investor when trading directly, on the investor's agent when trading indirectly, or on the marketplaces. At present there is no technology existing in Canada which an investor can use to automatically route orders intelligently among multiple Canadian marketplaces, let alone ensure compliance with a trade-through rule. Any order routing mechanisms currently on desktops are purely oriented to US/ Canadian market arbitrage.

Further, as of today, BlockBook, the only alternative marketplace currently trading the same securities as the TSX, is not connected to any existing trade management system used by its clients. This is not because such a connection would be undesirable, or that MSI has not tried to achieve these connections; quite the contrary. A direct connection with traders' management systems would alleviate a substantiate workflow burden that now inhibits some clients' use of BlockBook.

The truth of the matter is that the vendors of these systems reasonably wait until a critical mass of their clients demand electronic access to a particular marketplace and clients have a hard time making these demands in advance of confirming that the marketplace has value through use. Therefore, it is impossible for a start-up organization, with no history or proof of value, to compel or even entice the vendors of these systems to spend money today on system changes in anticipation of future success. While this is a general truth worldwide, this dynamic is especially prevalent in Canada where there has yet to be a successful alternative marketplace.

If the trade-through protection obligation were to fall on all market participants, therefore, system changes on all the trade management systems used by all the clients who desire to use multiple marketplaces would be required prior to that marketplace's operation. MSI conservatively calculates that would represent approximately 15 - 20 systems each spending approximately 100 hours of development time to accommodate this change. In addition, there is a risk of delay, particularly on systems which operate predominantly outside of Canada, where the ability to get new projects on the development queue is severely limited.

These hard costs will apply whether the investor is a dealer or institutional investor, however they will generally be greater both in absolute terms and on a relative basis for the institutional investor as a result of the additional constraints required to reflect their more stringent internal compliance regime with respect to permitted trade types, sizes, etc. and their greater sensitivity to the reputational risks of non-compliance. Plus, an institutional investor has generally less of a base of technology to work from and a smaller book of business to support these expenditures than a dealer.

If the trade-through protection obligation were to fall on the marketplaces, there might be some cost saving when looking at total expenditures across the whole market, however the concentrated burden on the marketplaces would be that much greater. Each marketplace would now be required to develop a smart order routing capability and the ability to connect with every other marketplace. MSI conservatively estimates that the development of such a capability for one marketplace would cost in excess of $1M and take 6 - 9 months to implement. Obviously, this burden falls harder on the new entrant who must increase the investment required to bring the product to market than the incumbent marketplace who can fund these changes through current revenues.

Reputational Risk
Under both scenarios, however, over and above the hard development and compliance costs is a much greater potential cost to competition and innovation. A substantial concern for many institutional investors and dealers is the reputation and compliance risk associated with a trade-through protection regime. The risk of breaching internal or legislated constraints against short-selling, for example, if the institutional trader miscalculated his displacement obligation, would easily negate any potential advantage of accessing multiple marketplaces. Also, the impact to an institutional investor of a compliance breach can be franchise threatening (e.g. RT Capital, market timing). Similarly, dealers who have a substantial retail business are particularly sensitive to compliance breaches which could be portrayed as being harmful to the small investor. The compliance risks of a trade-through protection regime would thus directly hamper the ability of new marketplaces to acquire clients and would entrench existing market structures.

MSI has direct experience with this issue for both its dealer clients and institutional investor clients. The biggest concern that dealer clients have when joining BlockBook is the compliance issues that arise from fulfilling their existing trade-through obligations. This concern has caused some dealers to constrain their use of the system to pegged orders (orders where the price is referenced to the TSX quote) thus limiting the value of the system and its potential for true price discovery, which would benefit the market as a whole.

Even more serious has been the reluctance of some major institutional investors to join BlockBook at all, not because they disagree with the model or do not see the value. On the contrary, they would very much like to support this innovation in the market, but are so concerned about perceived reputational risk regarding trade-throughs, they have declined to participate. To take this position now, even when there is no current legal prohibition against an institution trading-through, is, in our view, the clearest demonstration of the chilling effect that trade-through protection can have on market innovation and competition.

Impossibility of Mandating Marketplace Co-operation

If the compliance obligation were to fall on the marketplaces there would be even greater negative impact on competition and innovation. For two marketplaces to be able to exchange orders, a significant joint undertaking must be made. Notwithstanding the tremendous advances in technology standardization of messaging, there is still a requirement for agreement on the format, content and handling of orders. Therefore it is not something one marketplace can accomplish independently, but requires the cooperation and the commitment of resources from the other marketplace.

This required "handshake" between two markets would be the chief constraint on new markets starting up. There is no incentive for the incumbent market to prioritize a project that may gain it a competitor and there are real issues of compatibility that can be difficult to resolve. Some of these issues are purely technical. For example, the TSX still uses a proprietary message protocol (STAMP) while the rest of the world has migrated to FIX. MSI designed BlockBook to be completely FIX compliant. Any type of integration with the TSX would require MSI to create a one-off FIX-to-STAMP interface and thereby constrain us by the other market's technology choices.

Forced Integration as a Constraint on Innovation

While the purely technical issues can be resolved with time and money, the more difficult issues arise where there is a lack of order or operational compatibility. A trade-through protection regime which requires orders to be sent from one marketplace to another works best where all the orders are substantially alike and all marketplaces operate in substantially the same manner. However, it is easy to see how the requirement of a "handshake" between markets becomes rapidly more complicated when there are substantial differences across any of these parameters. Here is the real constraint on innovation: the more different and innovative the new marketplace, the more difficult to establish the required integration to prevent trade-throughs.

Specialized marketplaces such as BlockBook cater to clients and orders with substantially different characteristics than what is typical on the TSX. Therefore, prior

to routing orders between our two markets we would need to agree on multiple issues. For example: 1) eligible clients - neither MSI nor many BlockBook clients are POs – how would they be able to execute on the TSX? 2) order size - BlockBook minimum order size is 25,000 shares – obviously the whole order can't be sent as is to the TSX – what are the decision rules governing how the order is broken and what happens to the residual? and 3) the business arrangements between the markets - who pays for the communication charges, what are the cost/revenue implications; how will settlement occur?

If MSI had been required to resolve all of these issues as a prerequisite for market operation, I am very confident in stating that we would not have been able to convince our shareholders to take this unbounded business risk. For a start-up with limited capital, the risk (including that of delay caused by the dependence on the co-operation of a competitor) would have been too great to overcome.

The great irony in this entire discussion is that while the requirement for markets to integrate as a pre-condition of operation is a huge impediment to new entrants, once a marketplace has established a client base and a reasonable likelihood of success there is a natural two-way motivation to achieve at least some level of market integration. Evidence of this evolution abounds both in the US market and now in Canada. MSI is currently in productive discussions with the TSX to resolve the thorny issues that are listed above in order to achieve an agreed level of integration. This was not possible prior to our establishing a credible operation as a stand-alone marketplace. Now, however, there is a mutually recognized benefit to our clients, and consequently ourselves, in finding those areas of integration that enhance the probability of good executions. The side-benefit of even this limited integration is to reduce the possibility of trade-throughs from occurring.

It is important to emphasize that we are not making a complaint about the TSX's actions to date. This example simply demonstrates the limitations of regulatory compulsion and the much greater power of self-interest to drive changes.

We further believe that that fact that there were no competitive markets even attempted during the period where NI 21-101 effectively required marketplace integration, and the fact that subsequent to the revocation of this requirement we now have several launched and proposed new marketplaces, is additional evidence to support the competition limiting effect of forced integration.

The US example offers many insights into the trade-through discussion; however it must be tempered by the fundamental differences between the two markets. The landscape in the US (where Reg NMS is being imposed) was one of multiple public

limit order books with substantially the same client base, matching methodology and order characteristics which had already put in place most of the technological interfaces required to accommodate trade-through protection. Even then, we note the controversy and extensive comments associated with the new rule. However it is perhaps understandable that in the context of such an abundance of competitive marketplaces, the SEC could afford to weigh the balance in favour of a rule which carries potential negative consequences for competition. The challenge for the CSA, therefore, is to decide if the possibility of trade-throughs occurring prior to the achievement of this state of competitive vibrancy generates sufficient risk to market integrity to warrant the real and tangible harm to competitive markets and innovation that trade-through protection would bring. That is, do the assumed benefits of a pre-emptive trade-through protection outweigh the tangible negative consequences of limited investor choice for execution venues and trading methodology?

Benefits of Trade-through Protection

Advocates of trade-through protection posit that it is fundamental to ensuring investor confidence in the public equity markets. This position, which is well-captured in the CSA discussion paper, believes that without trade-through protection, investors will have less incentive to place their limit orders on a marketplace thus hampering liquidity and the price discovery process. This concern is expressed most forcefully in relation to the retail investor, who is presumed not to have the knowledge or skills to understand why a trade-through may logically occur.

Unfortunately, there is no concrete evidence to support any of these assertions. (We note this was one of the most controversial aspects of the US debate – especially in the face of the abundance of NASDAQ limit orders which did not have trade-through protection). Advocates are therefore forced to rely on theoretical arguments of free options, fragmentation and free riding on the public market's price discovery mechanism. While we acknowledge these concerns, we dispute the conclusions and therefore the justifications for trade-through protection.

First, we do not believe that the only logical reaction of an investor whose order has been traded-through is to stop submitting limit orders to the market as a whole. Surely an investor who has always entered his orders on Marketplace A, but saw them routinely traded-through on Marketplace B, would be inclined to try submitting an order to Marketplace B, prior to abandoning the markets all together? Further, even if that particular investor does not have the ability to access Marketplace B for whatever reason, we know there will be others who do and who will happily buy on Marketplace B and sell on Marketplace A, thus providing liquidity for the initial investor. This natural arbitrage activity is a much more effective tool in keeping market prices aligned than regulatory constraints. We in Canada see this every day in the tremendously

efficient arbitrage which exists in cross-listed securities between Canada and the US. While it is true that most Canadian retail investors do not have ready access to the US markets, the professional traders ensure that there is no significant pricing differential between the two marketplaces, thus allowing the Canadian retail investor to benefit indirectly from the liquidity and price discovery in the US markets.

Second, we disagree with the notion that trade-throughs are evidence of the exploitation of a free option or represent free riding on another marketplace's price discovery mechanism. The price formation process, wherever it takes place, incorporates all known information about a security, the economy, etc. Naturally, the quoted prices of one marketplace will contribute to the price formation process of another marketplace, and vice versa. Logically, however, if an execution occurs at a different price on Marketplace A than the publicly quoted price on Marketplace B, it must incorporate some additional factors not present in the first marketplace's price. These factors could relate to the specifics of the trade (e.g. size, special conditions) or to the motivations of the trader (e.g. urgency, execution certainty). Therefore, it is more accurate to consider a trade-through as contributing to the overall price discovery mechanism of the market as a whole, rather than detracting from it. This position is supported by the BlockBook execution evidence to date where, in the few cases of trade-through, market participants quickly displaced the better priced orders following a trade-through, even in the absence of a regulatory obligation to do so.

Fostering transparency in price discovery is a fundamental value which we believe is put at risk by the existing trade-through rules that apply to dealers, and therefore by the RS proposal which would extend this same obligation to Access Persons. By requiring a dealer to displace all better-priced orders prior to publishing the execution price of a block trade, the rule presumes that the investor with the better-priced order values liquidity to the exclusion of all other information that may be very relevant to the investor's trading decision. For example, if the block trade is executed at a discount and immediately published, an investor might conclude that his better-priced bid is, in fact, mis-priced and would value the opportunity to change his limit price prior to execution. Similarly, an investor who has a "stop-loss" order may feel very aggrieved if his order is executed during a displacement exercise, only to see the price return to normal immediately after. We believe that allowing all investors, not just those privy to the information on the block trading desks of the major dealers, the execution information of block trades prior to any displacement exercise would substantially improve the current market's transparency and thereby its integrity and operations. Investors would have the opportunity to react to the information contained in the block price thus greatly improving the overall price discovery mechanism.

Third, we have been confused by the inconsistent positions taken by trade-through proponents regarding retail client protection, promoting public market liquidity and fragmentation. For example, internalization by dealers is by far the biggest contributor to fragmentation and reduced market liquidity, as its entire purpose is to divert orders away from the public marketplace. Plus, the benefits of internalization accrue entirely to the dealer. Yet, we note that neither the CSA nor RS has addressed this issue with the same fervor as trade-through. One explanation given for this seeming contradiction is that most internalized retail orders are market orders, not limit orders, and are therefore not contributing to the price discovery mechanism and so do not need to be submitted to the public market. If true, this should reduce the concern that trade-throughs may contribute to the "perception" of inappropriate activity because the displayed limit orders are not unsophisticated retail orders, but are those of investment professionals that are quite capable of understanding the reasons for price differentials across trades or markets. This is an area that could benefit from greater research.

Finally, leaving aside these theoretical arguments, the benefit of trade-through protection is sometimes expressed more generally as being consistent with a fundamental value of fairness. We agree with this fundamental value, however, in the case of trade-through protection, this view requires the somewhat simplistic belief that the public equity markets function best as a large "pot" in which all orders are contributed and price/time priority is the only criterion for which orders get filled. We all know that the "one pot" view of the Canadian equity markets has never been accurate, let alone the most desirable, even before the advent of competitive marketplaces.

There are already many examples of legitimate trade-throughs occurring every day with no measurable negative impact on investor confidence or the value of fairness. Special Terms orders are specifically exempted on the basis of order incompatibility with orders in the public limit book. Similarly, new issues are permitted to by-pass better-priced displayed orders and wide distributions also benefit from different rules regarding the obligation of better-priced orders.

Each of these exceptions has a coherent rationale. We do not disagree that these situations warrant exemptions from the trade-through requirements. We would merely suggest that they prove that what is really important to investor confidence is that, if an order is traded-through, there is a clearly identifiable and justifiable reason for the trade-through.

We believe that it is important not to underestimate the capacity of the retail investor to understand different prices occurring on different marketplaces. For example, even an unsophisticated retail investor can understand that the price for 1,000,000 shares may

be different that the price for 100 shares. This is a basic economic principle that they experience every day in non-financial transactions (and is why Costco and Wal-mart have been so successful). The retail investor also experiences price differentials in transactions of other financial products. No one expects the foreign exchange rate to be the same for $10M as for $100. No one expects the interest rate on $10M to be the same as on the average saving account.

We note that the new block trading facility of the Bourse de Montreal achieved an exemption from the trade-through protection requirements with no market threatening consequences to date.

Further, there are other, less defensible chinks in the "one pot" structure which have been incorporated over time for the advantage of some market participants. Internalization is certainly an example of this, as is TSX rule 4-802. We understand that this rule allows an order from one dealer to step ahead of an equivalently-priced order with time priority to match with another order from the same dealer. If internalization largely applies to market orders, the in-house client priority rule is, in essence, internalization for limit orders. The "first come, first served" aspect of time priority is surely as important to investor confidence and to the values of fairness and market integrity as best price. The benefits to the dealer are obvious – the same firm collects commission on both sides of the trade and boosts their execution performance. The benefits to fairness and to the market as a whole are less obvious. A legitimate limit order, which has contributed to the price discovery mechanism of the marketplace, has been by-passed. This is exactly the same expression of "harm" that proponents of trade-through protection are so keen to prevent, however in this case it has occurred on the same marketplace, and yet the rule has been in effect for many years with no public outcry and no strongly worded concerns about the impact on market integrity.

We would also argue that to be logically consistent, concerns should be raised about those marketplaces which make no contribution to price discovery, but are designed to match limit orders before they get to the public marketplace, thus reducing the possibility for "competition among orders" which is another benefit attributed to trade-through protection . Examples of this type of marketplace are crossing networks (POSIT) or other facilities where price is strictly a derivation from the publicly quoted price (TRIACT). This type of marketplace, therefore, is a true free-rider on the price formation process of another marketplace and also contributes to market fragmentation without any compensating benefits of contribution to price discovery. Ironically, this type of marketplace has proved to be the least controversial of all which have been proposed.

Suggestions for consideration

1. If the CSA agrees that trade-through protection carries even some negative impact on competition and innovation among marketplaces, we hope an extremely cautious approach is taken. It must be acknowledged that the Canadian capital markets have not benefited from as much innovation as elsewhere, especially when compared to the US. So if there is a balance of interests to be decided, we would hope the balance would be cast in favour of the weakest side (i.e. that having the least impact on competition). The CSA took just this position when it repealed the market integrator and data consolidator requirements that were originally imbedded in NI 21-101. In our view, that action was entirely responsive to the Canadian situation. When faced with the evidence that this requirement was an impediment to competitive markets, the CSA repealed it and was satisfied that a focus on best execution, transparency and fair access would be sufficient to protect the Canadian investing public. It would be a terrible shame to undo that good work (which is already showing positive results in the form of new marketplaces starting subsequent to that decision) by imposing a different constraint with the same negative results.

2. If, notwithstanding all the arguments to the contrary, the CSA remains concerned about allowing the market to be continue to be unconstrained with regard to trade-throughs, we would suggest a thorough investigation of implementation ideas which are designed specifically to reduce the potential negative impact on competition and innovation. For example, if the principal concern is the potential perception of inefficient/unfair markets by the unsophisticated retail investor, we hope the resulting regulations are constrained to address only that concern. Obviously, this would preclude the implementation of RS's interim proposal.

3. Our specific suggestions on the best design of a rule, starting from first principles, would generally fall into three categories: i) limit the circumstances requiring trade-through protection to those which are specifically of concern; ii) reduce the uncertainty surrounding the displacement obligation to facilitate compliance and trading decisions; and iii) allow flexible implementation options to accommodate different trading methodologies.

Here are some preliminary ideas which we believe could be useful in this regard:

i) Limit protected orders to only those of concern

- Exemptions for orders that would not naturally match or have a readily understandable explanation
    - existing Special Terms
    - any contingent or linked orders (Baskets, portfolio trades etc)

    - orders of a size that would affect the market price (block trades)

- Exemptions for trade-throughs below a threshold – *de minimis* target where the costs to displace outweigh the "harm"
    - Price based – e.g. 3 – 5 cents or % of market price
    - Cost based – e.g. total value of trade-through (price difference X displayed shares) would have to exceed the transaction and settlement charges of executing the displacement. This would be best as a set dollar amount reflecting average costs e.g. $100 per trade
    - Time-based – e.g. only those orders that have not been displaced by "natural arbitrage" after 60 seconds

- Only retail limit orders are protected
- Top of book rather than full depth

ii) Reduce uncertainty of obligation

- Fix displacement obligation
    - Obligation is fixed maximum amount e.g. average displayed order size
    - Obligation is limited to the excess of the original order size (where this is verifiable by an electronic audit trail)
- Define the obligation clearly in an explicit rule rather than policy or interpretation

iii) Flexible implementation

- Displacement occurs post trade
- Displaced orders have opportunity to react to price information (may reject displacement)
- Displacement can be achieved by non-trade-through party
- Cash payment option rather than only displacement

<u>Conclusion</u>

MSI is grateful for this opportunity to submit its views and looks forward to the public forum where these areas of interest to the Commissioners may be expanded. In particular, MSI commends the CSA for taking the time necessary to conduct a comprehensive and thoughtful analysis of this important and complex issue.

The most difficult task for the CSA, given the lack of actual experience within Canada, will be to ensure that there is clarity and hard evidence regarding the "harm" any rule is intended to address and that the benefits clearly outweigh the costs, both explicit and otherwise, including the cost to competition and innovation.

If the CSA maintains the current purpose of the existing trade-through rule as a duty to the client, or as a back-stop to the dealer's obligation of best execution, we would support an "opt-out" or other accommodation to eliminate a rule discrepancy when trading directly or through a dealer.

If, on the other hand, the CSA decides to re-characterize the trade-through rule as an obligation to the market generally, we strongly oppose the simplistic extension of the existing rule to all investors, as proposed RS. Rather, we urge the CSA to craft a realistic rule from first principles which adequately considers the special constraints of institutional investors and finds a way to temper the concomitant anti-competitive side-effects.

Whatever the outcome, the CSA should to proceed with caution and an adequate implementation period to minimize the real potential for unintended consequences overwhelming the justifications for imposing this additional regulatory burden.

Yours truly,

"*Judith Robertson*"

Judith Robertson
President and CEO