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BY E-MAIL

Members of the Canadian Securities Administrators

c/o John Stevenson, Secretary
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- and –

Anne-Marie Beaudoin
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Dear Sirs/Mesdames:

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

1. Introduction and Overview

Market Regulation Services Inc. ("RS") is pleased to have the opportunity to provide its second comment on the Canadian Securities Administrators' Discussion Paper 23-403 – *Market Structure Developments and Trade-Through Obligations* (the "Discussion Paper").

In its initial comment, RS took the following positions:

- RS supports the need for trade-through obligations that benefit investors on Canadian marketplaces.

- The trade-through obligation is properly understood as an obligation that is separate from the duty of best execution and that is owed by market participants to the market and other market participants.

- Market regulation should, above all other goals, protect investors.

In Part 3 of this comment RS presents data to date on trade-throughs on the marketplaces that RS regulates, specifically Markets Securities Inc., TSX Venture Exchange and the Canadian Trading and Quotation System.

Part 4 of this comment provides RS's analysis of the impact of trade-through obligations on innovation and competition.

Based on its analysis, **RS reiterates its support for trade-through obligations that benefit investors on Canadian marketplaces.** RS also believes that **it is critical that the CSA implement neutral trade-through obligations as soon as possible**. As Part 3 demonstrates, trade-throughs are occurring on Canadian marketplaces, and there is considerable regulatory uncertainty surrounding trade-through issues that require resolution.

In deciding between the market participant-level solution and the marketplace-level solution, the CSA should take into account readily-available comparative information about the direct costs of these alternatives. However, this analysis should not further delay the implementation of neutral trade-through obligations.

As RS noted in its first comment, **the marketplace-level solution proposed in the Discussion Paper must be supplemented by a parallel obligation on market participants in connection with their trading outside Canada**. **RS believes that, on balance, this supplemented marketplace-level solution will be more comprehensive, neutral and effective than the market participant-level solution**.

The marketplace-level solution offers the following advantages:

- orders on all marketplaces are protected, regardless of individual market participants' access decisions;

- a smaller number of linkages among a smaller number of marketplaces is required to implement automated trade-through protection, reducing collective action problems that would increase among a larger number of market participants;

- the number of regulated entities to be monitored by regulators is smaller; and

- trade-through obligations can be automated (i.e., "system enforced") on a central basis by marketplaces.

RS believes that the chief advantages of the market participant-level solution relate to the comparative technological and contractual complexity of the marketplace-level solution. The

CSA should therefore focus on implementing the marketplace-level solution in a manner that minimizes latency and/or delay in order execution and addresses the contractual complexity created by order routing among marketplaces. The CSA should also monitor the interactions among marketplaces for inappropriate impediments to entry and competition.

Part 6 of this comment provides RS's responses to the specific questions asked in the Discussion Paper.

2. About RS

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

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

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

3. Analysis of Trade-Throughs on Canadian Marketplaces

RS has been collecting and analyzing data relating to trade-throughs on the marketplaces it regulates. **Trade-throughs are occurring on Canadian marketplaces.** Trade-throughs have occurred on MSI in securities listed on the TSX, and on the TSXV and CNQ in securities interlisted on those marketplaces.

For the purposes of this data and analysis, a trade-through is recorded when a better-priced order is traded through by a Participant or Access Person that has "access" (as defined in Market Integrity Notice 2005-016 – *Request for Comments – Interim Provisions Respecting Trade-Through Obligations* (May 12, 2005)[1]) to the marketplace with the better-priced order.

When viewed on a trade-by-trade basis trade-throughs do not involve large dollar amounts. For example, if a better-priced order for one thousand shares is traded-through by five cents, the "amount" of the trade-through is fifty dollars. From the perspective of the party who traded through, this is the amount that he or she lost by trading at an inferior price. This is the side of the transaction that the duty of best execution addresses.

As RS explained in its first comment, however, the trade-through obligation protects the investor who placed the limit order that was traded-through. The harm to this investor is the lost opportunity to trade at the time that the trade-through occurred, and the increased risk the investor bears while his or her order is unfilled. But RS believes that the harm involved in trading-through is not simply the total of these lost opportunities and the increased risk. Instead, the more significant harm is found in the impact of trading-through on investors' incentives and

[1] (2005) 28 OSCB 5064 ("MIN 2005-016").

their perception of the fairness and the integrity of the market, and how this will, in turn, affect spreads and the depth and liquidity of the market. (RS reviewed this analysis in detail in its first comment.) These are effects that will not necessarily be measurable in the short term.[2]

Even if permitted trade-throughs were to be limited to large transactions (as Question 22 of the Discussion Paper suggests), the impact of such trade-through activity could be significant. In the five trading days from October 3-7, 2005, there were over 6,600 block trades of 25,000 or more shares on the TSX, representing over 582 million shares traded with a value of over $10 billion.

Finally, it must be remembered that many other UMIR violations typically involve similarly small dollar amounts when viewed on a per-trade basis (such as manipulative and deceptive activities, short-sale price restrictions and client priority), but also have significant implications for market integrity when considered in terms of their overall impact and their effect on investors' perceptions of the fairness of the market as a whole.

MSI Trade-Throughs of TSX

MSI trades all TSX-listed securities. Between August 22 (the launch date for MSI) and October 19, 2005, there were 22 trade-throughs on MSI, out of a total of 36 trades over the period.

Trades on MSI that traded through better-priced orders on the TSX represented 50.4% of total trading by volume and 53.5% of total trading by value on MSI over the period.

These 22 trade-throughs on MSI traded through better-priced orders on the TSX 110 times. On average, five better-priced orders were traded through in each case, and the visible volume of better-priced orders was 14.6% of the size of the MSI trade. These data demonstrate that trading through is having more than a "de minimis" impact in terms of the number and volume of better-priced orders that are traded through.

The amount of the trade-through ranged from $0.01 to $0.28, measured as the difference between the MSI trade and the *best*-priced order on the TSX. Where more than one order was traded-through, other orders that were traded-through would have been closer to the price of the trade on MSI, and the amount of the trade-through smaller.

According to data provided by MSI, trades on MSI to October 13, 2005 represented on average 18% of the average daily volume in the security traded. The MSI trades involved in trade-

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[2] There is little concrete empirical data on the impact of trade-throughs on market quality. A recent academic study analyzed the impact of a three-cent *de minimis* exemption to the trade-through rule initiated by the SEC in September 2002 as it applied to three heavily-traded ETFs. The authors found that the exemption did not worsen market quality (based on effective and realized spreads and the efficiency of price discovery), but warned that their results were not conclusive. As they noted: "A look at the frequency of trade-throughs provides part of the explanation: the new rule has almost no effect on the likelihood of trading through. In these ETFs, we establish that the various markets are already trading through with abandon, so the exemption simply represents a case of the rules catching up to practice. The three cent trade-through exemption is close to a non-event for these ETFs." The authors also stated: "In the current regulatory debate over the proposed Regulation NMS, some are trying to use the ETF *de minimis* exemption as evidence that trade-through rules have no effect on market quality. Our paper cautions against that kind of conclusion and urges restraint in interpreting the results of this regulatory change." The authors did not examine the impact of the exemption on the flow of limit orders. Terrence Hendershott and Charles M. Jones, "Trade-Through Prohibitions and Market Quality" (2005) 8 Journal of Financial Markets 1.

throughs represented on average 6.6% of average daily volume. If trade-throughs on the same security on the same day are grouped together as a single trade, the trade-throughs on average represent 16.5% of average daily volume.

The majority of the orders that were traded-through were client orders, and the average size of those orders is smaller than the TSX average.[3] Not all of the orders that were traded through were eventually filled; some were cancelled or changed subsequent to the trade-through.

All but one of the trade-throughs on MSI over this period were by Access Persons, and several Access Persons have caused multiple trade-throughs. RS believes that this experience indicates that regulatory arbitrage may be the motivation for some of these trade-throughs, since the same trades would be subject to trade-through obligations if placed through a Participant for execution on the upstairs or the regular market of an exchange.

TSXV Trade-Throughs of CNQ

Until October 17, 2005, there were two securities interlisted on the TSXV and CNQ – Solex Resources Corp. (TSXV – SOX; CNQ – SOLX) and United Reef Limited (TSXV – URP; CNQ – URPL). Solex Resources Corp. voluntarily delisted from CNQ on October 17, 2005.

Between June 1 and October 19, 2005, better-priced orders on CNQ were traded through 70 times on TSXV. Trades on TSXV that traded through better prices on CNQ represented 3.16% of total trading by volume and 2.56% of total trading by value on TSXV in the two interlisted securities over the period.

In the majority of cases, a single order was traded through.[4] Not all of the orders that were traded through were eventually filled.

RS has determined that all of these cases were inadvertent, in part because the same securities have different ticker symbols on the two marketplaces and in part because the dealers involved did not have ready access to the marketplace with the better price.

CNQ Trade-Throughs of TSXV

Between June 1 and October 19, 2005, there were two trade-throughs on CNQ of a single better-priced order on TSXV. These trade-throughs were inadvertent. The orders that were traded through were filled.

4. Impact of Trade-Through Obligations on Innovation and Competition

A report of the IOSCO Technical Committee identified four principal areas in which providers of trade execution services compete:

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[3] The average size of the orders traded through was 837 shares. The average size of an order on the TSX in September 2005 was 1,159 shares (TSX Statistics – September 2005).

[4] Because the trade-throughs were inadvertent, in a significant number of cases the volume of better priced orders was greater than the volume of the order that traded through.

- product development: primary and secondary listings; international index products, derivative contracts;

- alternative trading systems or methods: order-matching systems, guaranteed liquidity providers, reference price crossing systems;

- service and efficiency: lower transaction costs, better technology, general efficiency, added value services (e.g., straight-through processing and central counterparty clearing); and

- internalization and payment for order flow: competition between markets and brokers.[5]

The IOSCO Report identified the following benefits of competition between trading venues; such competition:

- breaks down monopolistic practices and increases efficiency;

- brings downward pressure to bear on transaction charges;

- stimulates innovation and offers users a range of trading methods more finely tuned to their needs; and

- attracts greater participation.[6]

The same report noted, however, that "any benefits may be more than offset by a number of disadvantages which potentially include:

- the duplication of costs, including 'search', operating and regulatory costs;

- the introduction of trading methods and business practices that may diminish efficiency and not be in the best interests of the market as a whole; and

- the diffusion of liquidity, and an adequate level of it, that (despite arbitrage) has the end result of reducing price competitiveness, undermining the concept of time priority, and increasing volatility."[7]

The IOSCO Report concludes its description of competition and innovation by noting that

> "in practice, the overall impact of competition on market quality is likely to depend on the nature of the existing market structures and the types of competition that emerge. While

[5] IOSCO Technical Committee, *Transparency and Market Fragmentation* (2001) ("IOSCO Report") at pages 5-9.

[6] IOSCO Report at pages 9-10.

[7] IOSCO Report at page 10.

regulators need to take care that competition does not impair overall transparency and liquidity, they need also to recognize that some forms of competition may enhance them."[8]

The report of TSE Special Committee, *Market Fragmentation: Responding to the Challenge* (1997) (the "Market Fragmentation Report") identified the same trade-offs expressed in terms of consolidation and fragmentation.[9]

This Part identifies what RS considers to be the most important arguments relating to competition and innovation. It considers the impact of trade-through obligations per se (i.e., regardless of how they are implemented), and then the advantages and disadvantages of implementing trade-through obligations at the marketplace level and the participant level.

As noted above, RS believes that investor protection should be the primary concern of regulation in this field. However, **RS also agrees that regulation should avoid any unnecessary impairment of the potential for innovation and competition among marketplaces**.

RS therefore agrees with the commenters who reconciled these two values by stating that marketplaces should "create new ways to compete that do not compromise investor protection and market liquidity",[10] that "competition must be based on robust standards of fairness and market integrity"[11] and that "Innovation should not be bought at the expense of fairness."[12]

Impact of Trade-Through Obligations Per Se

It is important to remember that competition is not desired as an end in itself, but rather because it can, under the appropriate conditions, lead to economically efficient outcomes for society as a whole. Competition certainly plays this role in the ideal economic world of the "first-best": the circumstances in which all of the conditions for perfect competition exist. In the first-best world, there is no need for government regulation.

Market structure regulation, on the other hand, occupies the real world of the "second-best". The second-best world is one where the conditions for perfect competition do not exist because market distortions (such as externalities and public goods) exist. As RS argued in its first comment, where these conditions exist, there is an economic rationale for regulatory intervention.

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[8] IOSCO Report at page 10.

[9] The Market Fragmentation Report defined fragmentation as "the dispersal of buy and sell orders for *the same security* among separate securities markets and private trading systems." (emphasis in original, at page 2) The IOSCO Report defined fragmentation as "the existence of multiple market centres (exchange markets, over the counter (OTC) market makers and Alternative Trading Systems (ATS)), through which the same securities are bought and sold. As a result, the location of buying and selling interest for individual securities is 'fragmented' to the extent that quotations and orders in different trading venues do not have an opportunity to interact." (at note 5)

[10] Comment letter dated September 26, 2005 from Scotia Capital Inc., at page 5.

[11] Comment letter dated September 19, 2005 from TriAct Canada Marketplace LP, at page 2.

[12] Comment letter dated September 19, 2005 from TriAct Canada Marketplace LP, at page 4.

The most significant distortions in the "market" for marketplaces are the following:

- network effects and imperfect competition: commonly expressed in the phrase "liquidity attracts liquidity", the "liquidity externality" is a form of positive network externality that tends to work against competition;[13]
- asymmetric information: some traders are "informed" (i.e., they are trading on the basis of information about the future value of a security that other traders do not possess[14]) and other traders are "uninformed" (i.e., they are trading on the basis of something other than information, such as a need for liquidity). Uninformed traders would prefer not to trade with informed traders. The risk that they will do so gives rise to adverse selection costs: the cost associated with the positive probability that the trader on the other side of the trade is an informed trader who will profit from the trade at the uninformed trader's expense; and
- principal-agent issues: the interests of brokers ("agents") are not perfectly aligned with those of their clients ("principals"), leading to potential principal-agent conflicts and associated efficiency losses. It is this conflict that the duty of best execution addresses.[15]

In the second-best world, it may be welfare-improving to permit less-than-perfect competition given the existence of market distortions like liquidity externalities, asymmetric information and principal-agent problems.

Rational investors who join a new competitive marketplace act in their own self-interest, and therefore consider themselves better off.[16] Yet the full impact of entry depends on the relative economic efficiency of the new equilibrium compared to the old equilibrium. Unrestricted competition among markets causes market fragmentation and thereby reduces liquidity externalities. Fragmentation is therefore associated with reduced liquidity, higher overall trading costs and weaker price discovery.

Fragmentation reduces the benefits of trading for both informed and uninformed traders. For example, both types of traders face increased adverse selection costs in a fragmented market because, given a fixed number of informed traders, the likelihood of trading with an informed trader on a particular market increases as the number of traders trading on that market decreases. This effect is exacerbated if competition among marketplaces takes the form of "cream-skimming" where a new market attempts to attract uninformed traders (e.g., investors trading for liquidity purposes) from an incumbent market. This cream-skimming increases the

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[13] On the other hand, when liquidity pooling benefits lead to a single marketplace, that marketplace can earn monopoly profits that encourage entry of new marketplaces.

[14] This need not be "inside" information, but could be information developed by an analyst through research where trading on the information would not be prohibited or otherwise constrained.

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

[16] Note that this does not take into account potential principal-agent problems that may influence the decision.

adverse selection costs for traders on the incumbent market that is thereby left with a higher proportion of informed traders.[17]

A new marketplace may also choose to compete by restricting access to the marketplace to traders with certain characteristics (such as institutional investors, or dealers trading as principal). In this situation, a negative externality arises as competition among marketplaces increases for those market participants who qualify to participate in the new marketplace, while fragmentation is increased and liquidity reduced for those who do not.

Operating in the opposite direction is competition that reduces rents arising from market power, and in turn acts to increase liquidity as more trading occurs.

The fundamental issue, therefore, is the trade-off between the benefits of competition among marketplaces and the innovation it promotes, on the one hand, and the adverse effect of fragmentation, on the other hand. The regulatory task – when viewed solely within this narrow economic framework – is therefore to strike the appropriate balance between these two concerns.

There are two principal lines of argument based on the impact of trade-through obligations per se on competition and innovation. First, a strict price priority rule enforced across marketplaces will limit the set of business models available and the scope for competition on the basis of execution quality factors other than price.[18] That is, the rule inhibits the ability of new marketplaces to optimally differentiate their service from that of incumbent marketplaces, which reduces the profitability of entry and innovation. Instead, trade-through obligations could lead to a commoditization of execution quality that leaves little incentive to innovate.

In response, some commenters stated that existing standards of market integrity – including the status quo (prior to the launch of MSI and interlisting between CNQ and TSXV) in which trade-throughs do not occur – allow ample room for competition and innovation[19] and have argued that marketplaces will still be able to compete on the basis of pre-trade transparency, price, services and order types.[20]

Returning to the dimensions of competition among trade execution services described in the IOSCO Report, while a trade-through obligation may affect a new marketplace's ability to offer certain alternative trading systems or methods, it would not affect its ability to compete on the basis of service and efficiency, by offering lower transaction costs, better technology or added value services.

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[17] There can also be feedback effects where the increase in adverse selection costs reduces the amount of information gathered, which in turn increases the volatility of stocks, which in turn causes the most risk averse investors to substitute other investment vehicles, which further reduces liquidity.

[18] See, for example, the comment letter dated September 19, 2005 from Markets Securities Inc.

[19] Comment letter dated September 19, 2005 from TriAct Canada Marketplace LP at page 4.

[20] See, for example, the comment letter dated September 26, 2005 from Scotia Capital Inc. at page 5, the comment letter dated September 19, 2005 from CNQ at page 3, and the comment letter dated September 19, 2005 from BMO Financial Group at page 3.

As RS noted in its first comment letter, no current or prospective marketplace has stated that its business model is dependant on trading through better prices on other marketplaces, although certain marketplace characteristics (such as reduced levels of pre-trade transparency) increase the risk of trade-throughs occurring on a marketplace.

The U.S. experience provides some guidance. There is obviously a much higher degree of competition in the U.S. market, but there is no clear evidence as to whether competition is at optimal levels in that market.

For example, there is evidence that competition between the NYSE, on the one hand, and the regional exchanges and ATSs, on the other hand, involves "cream-skimming" of uninformed traders, and that marketplaces seek to differentiate themselves to reduce competitive pressures as much as possible. (That is, new markets may search for profitable "niches" that the incumbent market is reluctant to exploit itself because of concerns about the impact of internal fragmentation.) For example, crossing systems that set prices based on the primary market compete with the NYSE[21] and appeal to traders with low immediacy requirements, who will likely be uninformed traders (informed traders usually have high immediacy requirements since they are concerned with information leakage). Regional exchanges also may attract uninformed orders away from the NYSE floor.[22] Trading still takes place on markets where cream-skimming has occurred – resulting in a higher proportion of informed traders – but with significantly higher adverse selection costs. For example, one study suggests this is the case in after-hours trading on U.S. ECNs, which attract informed traders who have information that they do not expect to last into the next trading day.[23]

On the other hand, other studies suggest that the competition between Nasdaq and ECNs is more welfare-enhancing, in that ECNs may do more to promote quote quality than to fragment markets, and contribute more to price discovery because they attract informed traders who value immediacy and anonymity.[24] Of course, the competition between Nasdaq and the ECNs is subject to a significant regulatory intervention in the form of the SEC's order-handling rules imposed in 1997, and Reg NMS in 2005.

The U.S. experience provides insights into the trade-off between competition and fragmentation, but it offers no clear answer as to whether the balance has been struck in the most efficient manner. It does demonstrate that it is possible for unregulated markets to have either too much or too little entry (i.e., competitive trading venues) relative to an efficient outcome. This determination is ultimately an empirical matter.

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[21] Jennifer Conrad, Kevin Johnson and Sunil Wahal, "Institutional Trading and Alternative Trading Systems" (2003) 70 Journal of Financial Economics 99.

[22] David Easley, Nicholas. Keifer and Maureen O'Hara, "Cream Skimming or Profit Sharing? The Curious Role of Purchased Order Flow" (1996) 51 Journal of Finance 811.

[23] Michael J. Barclay and Terrence Hendershott, "Liquidity Externalities and Adverse Selection: Evidence from Trading After Hours" (2004) 59 Journal of Finance 681.

[24] Roger D. Huang, "The Quality of ECN and Nasdaq Market Maker Quotes" (2002) 57 Journal of Finance 1285, and Michael Barclay, Terrence Hendershott and Tim McCormick, "Competition Among Trading Venues: Information and Trading on Electronic Communications Networks" (2003) 58 Journal of Finance 2637.

The second principal line of argument is that trade-through obligations require marketplaces and/or participants to establish electronic connections, which may represent a barrier to entry for new marketplaces (particularly if an incumbent marketplace is able to dictate the standards for the connection between marketplaces or must cooperate in its implementation[25]) and limit the scope for competition on the basis of technological innovation.[26] With less competition and less threat of future competition, the incentives to innovate are less for the incumbent marketplace and the inefficiencies arising from the exercise of market power by the incumbent marketplace increase.

These connections between marketplaces or market participants are beneficial because they reduce fragmentation in a competitive context and thereby increase the liquidity externality for the market as a whole. But they will not necessarily be developed in the absence of a regulatory mandate, since a marketplace has no incentive to facilitate cream-skimming of its order flow, and because the network would suffer from underinvestment because it has the characteristics of a public good or common property.

As noted below in response to Question 12 from the Discussion Paper, a marketplace subject to a depth-of-book trade-through obligation would have to effectively handle the entire order book of each other marketplace for each security that is traded in common with the first marketplace. With the ratio of orders to trades on Canadian marketplaces increasing dramatically over the last few years and expected to continue to increase (as a result of an increasing reliance on algorithmic trading and greater accessibility of order entry technology in the hands of institutions and retail investors), the difficulty which each marketplace may face in handling the additional information may become a burden that could act as a barrier to entry.

Commenters have responded that marketplaces could have incentives to develop innovative technology that assists with compliance with trade-through and other obligations.[27] For example, Reg NMS did not specify the mechanisms that market centres should adopt to comply with the order protection rule; instead, it requires trading centers to establish, maintain, and enforce written policies and procedures reasonably designed to prevent trade-throughs.

The impact of this aspect of trade-through obligations depends in large measure on whether trade-through obligations are imposed at the marketplace level or at the market participant level. These issues are explored in detail in the following subsection.

Finally, in assessing these arguments relating to innovation and competition, RS believes that there are unique characteristics of the Canadian equity trading market that regulators must consider. First, the Canadian market, in contrast to the U.S., has been characterized by dominant marketplaces that do not compete directly with one another, but do face the disciplining influence of international competition from the U.S. and other jurisdictions.[28]

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[25] See, for example, the comment letter dated September 19, 2005 from Markets Securities Inc.

[26] See, for example, the comment letter dated September 19, 2005 from CNQ at page 5, and the comment letter dated September 19, 2005 from Shorcan ATS Limited at page 10.

[27] Comment letter dated September 19, 2005 from TSX Group Inc. at page 11.

[28] Comment letter dated September 19, 2005 from TSX Group Inc. at pages 8-10.

In addition, Canada has typically tolerated more domestic industrial concentration than the U.S., in part because the concept of minimum efficient scale dictates how many firms can operate in a market of a given size while achieving minimum costs, and the Canadian market is significantly smaller than the U.S. market.

RS believes that these arguments relating to competition and innovation do not conclusively decide the issue of whether or not trade-through obligations per se represent an unjustified impediment to competition or innovation within the narrow frame of economic efficiency. **Given the other values at stake in this debate that are not part of this competition analysis – investor protection, fairness and the predicted adverse effects of trade-throughs on market quality – RS therefore supports the continued need for trade-through obligations.**

Impact of Alternative Methods of Implementing Trade-Through Obligations

This section considers the relative impact on competition and innovation of the marketplace-level solution and the market participant-level solution.

The marketplace-level solution offers several apparent advantages in relation to promoting competition among marketplaces.

First, a network of marketplaces means that any market participant who is connected to one marketplace is connected to all marketplaces, reducing the number of linkages required to allow marketplaces to compete on the basis of price and to reduce fragmentation.[29] The same reasoning applies to the costs of complying with and enforcing a trade-through rule: the total cost of compliance and regulation for (a smaller number of) marketplaces could be less than the cost for (a larger number of) market participants.[30]

Second, a new marketplace that is competitive on price (i.e., by providing price-improving quotes) can, through connections to other marketplaces, get access to orders from market participants on those marketplaces without having to establish subscriber relationships or connections to a larger number of individual market participants.

Third, a marketplace-level solution could reduce fragmentation by removing from individual market participants the decision relating to which marketplaces to access. If this decision is left to market participants, fewer connections would likely be made than would be socially optimal because the positive liquidity externalities created by those connections are a form of public good. Each market participant incurs a fixed cost to connect to a marketplace but does not capture the full social benefits of making that connection. Given the fixed costs of connecting to a marketplace, not all market participants will connect to all marketplaces and fewer orders will interact with each other.

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[29] For example, if there are two marketplaces and ten market participants, all market participants can be connected by 11 linkages (i.e., a link between each market participant and one or the other marketplace, and a single link between the two marketplaces), whereas it would require 20 linkages if each market participant was required to link to both marketplaces.

[30] These arguments are also made in the comment letter dated September 26, 2005 from Scotia Capital Inc. at page 5, and the comment letter dated September 19, 2005 from BMO Financial Group at page 3.

Fourth, from the perspective of the competitiveness of Canadian markets internationally, the ability to access Canadian marketplaces through a single networked access point may be more attractive to foreign investors than having to establish multiple connections to disparate Canadian marketplaces.

Fifth, imposing the obligation on market participants may result in a relative disadvantage to smaller firms that would be more significantly affected by fixed compliance costs.

The marketplace-level solution also presents several apparent disadvantages in relation to competition among marketplaces.

First, a mandatory link among marketplaces will require the standardization of information flows, which may undermine the proprietary market mechanism of a new entrant. Requiring each marketplace to conform to a common linkage mechanism could also impair the adoption of new technology, as discussed in the preceding section.

Second, this common linkage mechanism among marketplaces could itself take on the characteristics of a form of common property or public good, which could lead to underinvestment in its development and maintenance. (The weaknesses of the Intermarket Trading System ("ITS") in the U.S. have been attributed in part to its public good nature.[31])

Third, guaranteed access to orders from other marketplaces based solely on price could reduce marketplaces' incentives to increase their individual speed, reliability and other service characteristics, or to innovate on these dimensions. Conversely, a trade-through obligation that was implemented at the market participant level would provide an "exit" mechanism to discipline marketplaces that do not perform well (i.e., market participants could terminate their access to underperforming marketplaces).[32]

Fourth, as RS noted in its first comment, viewed from the perspective of a new marketplace seeking a critical mass of subscribers (as opposed to the perspective of the social good of the market as a whole), a marketplace-level solution that required electronic connections between marketplaces could reduce the incentives that market participants would have to join a new marketplace. Where market participants know that they will have access to better-priced orders on all marketplaces as a result of electronic connections among marketplaces, there will be less incentive for them to incur the initial and ongoing costs to join a new marketplace, since doing so will not be necessary to access those orders. These issues would likely be most significant at the time that a new marketplace is attempting to establish its customer base. On the other hand, under a market participant-level solution each market participant would have to join a new marketplace if it wanted to access that marketplace's orders, creating a push towards the development of a customer base for the new marketplace.[33]

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[31] See Hans Stoll, "Market Fragmentation" (2001) 57 Financial Analysts Journal 16.

[32] This argument is also made in the comment letter dated September 19, 2005 from TriAct Canada Marketplace LP, at page 5.

[33] As was also noted in RS's first comment, this analysis does not take into account the other business features that a new marketplace might offer that would encourage a market participant to access that marketplace. Furthermore, electronic connections among marketplaces will not give market participants access to the full depth of the liquidity on a new marketplace since only better-priced orders would be subject to order routing.

Taken together, **RS believes that these arguments are not conclusive with respect to the choice between alternative methods of implementing trade-through obligations in relation to their potential impact on competition and innovation**.

Again, RS believes that other values at stake in this debate that are not part of this competition analysis – the need for comprehensive, neutral and effective trade-through obligations – favour the marketplace-level solution, as is explained in more detail in Part 5 below.

5. RS Position on Implementation of Trade-Through Obligations

Based on its analysis, RS supports trade-through obligations that benefit investors on Canadian marketplaces, and believes that it is critical that the CSA implement neutral trade-through obligations as soon as possible.

As the arguments above relating to competition and innovation make clear, neither the marketplace-level solution nor the market participant-level solution is ideal. Either solution would involve difficult and complex implementation issues. As RS recommended at the public forum on October 14, 2005, in deciding between the market participant-level solution and the marketplace-level solution, the CSA should take into account readily-available comparative information about the direct costs of these alternatives.[34] However, RS believes that this analysis should not further delay the implementation of neutral trade-through obligations.

As noted above, the marketplace-level solution proposed in the Discussion Paper must be supplemented by a parallel obligation on market participants in connection with their trading outside Canada. That is, market participants should not be permitted to trade through better-priced orders on a Canadian marketplace by directing their trading activity to markets outside Canada, but should remain subject to their obligation to displace those better-priced orders on Canadian marketplaces. RS believes that such an obligation is necessary in Canada to protect better-priced orders on Canadian marketplaces given the significance of trading in interlisted securities on Canadian marketplaces.

This supplemented marketplace-level solution offers the following advantages:

- orders on all marketplaces are protected, regardless of individual market participants' access decisions; that is, unless a market participant-level obligation also required market participants to have access to all marketplaces, a market participant could bypass better-priced orders on marketplaces to which it did not have access, limiting the scope of trade-through protection;

[34] For example, the comments on the Discussion Paper make contradictory assertions regarding the direct compliance costs associated with each alternative. Many of those who support the market participant-level solution state that order routing technology is widely available to automate compliance by market participants with the obligation. However, another commenter supporting the marketplace-level solution asserts that such technology solutions are not presently available to market participants. Information should be readily available to resolve this point.

- a smaller number of linkages among a smaller number of marketplaces is required to implement automated trade-through protection, reducing collective action problems that would increase among a larger number of market participants;

- the number of regulated entities to be monitored by regulators is smaller; a market participant-level solution would require regulators to develop the infrastructure to monitor and enforce compliance by a large number of diverse market participants; and

- trade-through obligations can be automated (i.e., "system enforced") on a central basis by marketplaces.

RS believes that the chief advantages of the market participant-level solution relate to the comparative technological and contractual complexity of the marketplace-level solution. For example, orders routed directly by market participants may be less likely to be subject to latency and/or delay once entered, and order routing by market participants among the marketplaces to which they have access gives rise to less contractual complexity than order routing by marketplaces.

RS believes that, on balance, the supplemented marketplace-level solution will be more comprehensive, neutral and effective than the market participant-level solution, and therefore will better protect investors from the adverse effects of trade-throughs. The CSA should, however, focus on implementing the marketplace-level solution in a manner that addresses the concerns relating to latency, delay and contractual complexity described above.

6. Answers to Specific Questions

RS's answers to the specific questions raised in the Discussion Paper are as follows:

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

In its first comment, RS submitted that **regulators should not seek to design market structure or drive trading decisions through regulation**. Instead, **RS believes that the regulation of market structure should, above all other goals, protect investors from the adverse effects of market failures, such as the negative externalities of trade-throughs**. Other benefits of allowing market forces to operate, such as promoting innovation and competition, should be pursued, but only to the extent that they are compatible with investor protection. RS also submitted that two other regulatory objectives support the use of regulation to protect investors in a manner that does not impede competition, innovation or otherwise interfere with market forces. First, **regulatory requirements should be marketplace-neutral**: RS believes that the existence of different regulatory requirements among marketplaces, or regulatory requirements that have a differential impact on marketplaces, create the undesirable potential to influence investor behaviour in unintended ways and to encourage regulatory arbitrage. In the context of the trade-through debate, RS believes that trade-through obligations, and the investor protection they provide, should apply equally to all marketplaces. Second, **regulatory requirements should create a level playing field among market participants**: RS believes that regulatory requirements should apply equally to all market participants, where the activities of those market participants give rise to similar market integrity risks. In the context of the trade-through debate, RS

believes that Participants and Access Persons should be subject to the same trade-through obligations (whether imposed on them directly or indirectly through a marketplace-level obligation) when trading the same securities.

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

RS believes that the debate on trade-through obligations should take into account the impact of trade-through obligations per se, and of different methods of implementing trade-through obligations, on innovation and competition, as discussed in Part 4 of this comment

(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.

RS believes that the current debate should be limited to the impact of trade-throughs on the Canadian equity trading markets. RS agrees with the commenters who have identified the many differences between the equity and fixed income markets that make a combined discussion of the two markets unhelpful.

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

Given that trade-throughs *are occurring* on Canadian marketplaces, RS believes it is essential for the status quo (prior to the launch of MSI and interlisting between CNQ and TSXV) – in which trade-throughs do not occur on Canadian marketplaces – to be protected during this process, which will likely extend well into 2006. Trade-throughs have not been a feature of equity trading in Canada and the practice should not be allowed to develop while the CSA considers its response to the introduction of multiple marketplaces.

RS's proposed interim measures would have reduced the number of trade-throughs to the extent possible within RS's jurisdiction. These measures unavoidably reflected the limited scope of RS's jurisdiction: as a regulation services provider, RS could not impose trade-through obligations on marketplaces. But they were within RS's jurisdiction to implement and enforce during the interim period, and they would have demonstrated a regulatory commitment to preventing the harm that trading through could cause to investor confidence and market integrity.

However, RS believes that the form of interim protection is less important than its existence. The CSA has jurisdiction to implement interim protection at either the market participant or the marketplace level. Some form of interim protection is necessary.

If the CSA decides not to implement interim trade-through protection, RS believes that it is critical that the CSA implement neutral trade-through obligations as soon as possible.

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

As RS noted in its first comment, Canada's markets are smaller and face competition from U.S. markets; they can ill-afford to lose the liquidity provided by limit orders, particularly at a time when the U.S. is moving to enhance the protection of limit orders under Reg NMS. Furthermore, efficient and effective price discovery is particularly important in Canadian markets which are comparatively less deep and liquid than U.S. markets.

As noted above, while RS believes that the marketplace-level solution recently adopted in the U.S. under Reg NMS is a useful model, it also believes that **a supplementary market participant-level obligation regarding trading outside Canada is necessary**. (That is, market participants should not be permitted to trade through better-priced orders on a Canadian marketplace by directing their trading activity to markets outside Canada, but should remain subject to their obligation to displace those better-priced orders on Canadian marketplaces.) RS believes that such an obligation is necessary in Canada to protect better-priced orders on Canadian marketplaces given the significance of trading in interlisted securities on Canadian marketplaces. Such "leakage" from the coverage of the Reg NMS order protection rule appears to have been considered immaterial by the SEC, and so the SEC did not extend the order protection rule to foreign trading.

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

In the ordinary course, the pricing of derivative securities reflect changes in prices of the underlying securities in the "cash" or equity markets. From this perspective, the price discovery mechanism for the derivative security is in large part dependent upon the functioning of the price discovery in the equity markets. To the extent that pricing in the equity markets becomes discontinuous as a result of frequent trade-throughs, the signals for the pricing of derivatives could be expected to result in derivative market makers increasing the size of the spread and reducing the volume committed at any price level due to the uncertainties resulting from the signals from the equity markets. **As such, the existence of trade-throughs in the equity markets will pose problems for the operation of the price discovery mechanism in both the equity and the derivative markets.**

Trade-throughs in the derivative markets would not have a comparable impact on the equity markets (particularly since UMIR requires trades in the equity markets that have been determined in part by transactions undertaken in the derivatives markets to be made within the context of the bid and ask prices in the equity markets).

(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?*

For the reasons set out in its first comment and further elaborated in this comment, **RS believes that trade-through obligations should apply where there are multiple marketplaces trading the same security**.

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

RS's response to this question is set out in Part 4 of this comment.

(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?

Trade-through obligations and best execution are two distinct and separate concepts. **RS believes that all market participants owe a general duty to the market to not trade through better priced orders.**

Prior to the consolidation of the Canadian equity trading markets in 2000, each of the exchanges had displacement requirements that prevented members from trading through better-priced orders on the exchange. These displacement requirements further provided that exchange members had to honour better bids or offers for interlisted securities on other Canadian exchanges of which they were also members. This was a separate obligation from the duty of best execution.

UMIR and the former marketplace rules have always provided that a Participant's displacement obligation applies even if the client consents to a trade at an inferior price.[35] These policies clearly indicate that the displacement obligation is separate from the duty of best execution that is owed to the client.

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

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

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

[35] UMIR Policy 5.2, Part 2.

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

RS's response to this question is set out in Part 5 of this comment.

(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, the decision must be made whether the system of each marketplace must be able to support the order marking of every other marketplace in the event that the order must be "routed" to the other marketplace. For example, the market making structure of the TSX provides that certain types of orders are not entitled to participate in the minimum guaranteed fill facility and must be marked "BK". If orders entered on another marketplace are capable of being "routed" to the TSX, then orders which are not entitled to a minimum guaranteed fill could simply be entered on the other marketplace to avoid the application of the TSX restriction. Such an eventuality would undercut the utility of the restriction imposed by the TSX. This simple example illustrates how special features and facilities of any marketplace could be degraded by the routing of orders from other marketplaces rather than through the entry of orders directly by market participants.

On the other hand, if the features of all marketplaces had to be accommodated by market participants on order entry, the process of order entry would become unwieldy if not unmanageable. One possible outcome would be pressure from market participants for marketplaces to offer "generic" trading facilities which would simplify order entry but reduce the likelihood of innovative or special features on individual marketplaces.

It is important to note that Reg NMS allows each market centre to design its own solution and does not attempt to impose a single technological solution on market centres in the way that the ITS did from the mid-1970's until the implementation of Reg NMS. It would appear possible for a market centre to satisfy its obligations under Reg NMS by the introduction of rules that shifts the burden of compliance to the market participants who would be expected to utilize "smart order routers" which are already prevalent in the U.S.

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

In the view of RS, the absence of a data consolidator makes it impractical to expect a market participant to have order information from marketplaces to which the market participant does not have access.

If the responsibility for ensuring adherence to trade-through protection is imposed on marketplaces prior to the execution of a trade, then each marketplace must effectively receive and consolidate order information from all competitive marketplaces before executing the particular trade. Depending upon the nature of the trade-through obligation (e.g., depth-of-book as compared to top-of-book), the marketplace may have to effectively handle the entire order book of each other marketplace for each security that is traded in common with the first marketplace. With the ratio of orders to trades on Canadian marketplaces increasing dramatically over the last few years and expected to continue to increase (as a result of an increasing reliance on algorithmic trading and

greater accessibility of order entry technology in the hands of institutions and retail investors), the CSA must be aware and take steps to address the fact that the problem which each marketplace may face in handling the additional information may become a burden that could effectively act as a barrier to the entry of new marketplaces in Canada.

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

The question of access fees is presently addressed in UMIR. UMIR does not attempt to regulate the fee which any marketplace can charge for access as each marketplace will have its own cost structure that needs to be covered by its trading fees. Instead UMIR provides that the amount of the transaction fee can be taken into account when determining whether a "better price" in fact exists on another marketplace.

National Instrument 21-101 – *Marketplace Operation* ("NI 21-101") has been amended such that each type of marketplace (be it an exchange, QTRS or ATS) cannot "unreasonably prohibit, condition or limit access by a person or company to services offered by it". The securities regulatory authorities therefore currently have the capacity to ensure that any access fees charged by a particular marketplace are "reasonable" without requiring that the fees be same across all marketplaces.

The statistical analysis of the incidence of trade-throughs presented in Part 3 of this comment letter is based on "notional" trade-throughs (e.g., when a trade is executed at an inferior price to the price of an order displayed on another marketplace). The existing provisions under UMIR allow a Participant to consider differences in transaction costs and other costs that would be associated with executing the trade when determining whether the price of an order displayed on another marketplace in fact represents a "better" price. In certain cases, a transaction that trades through a "displayed" price by one cent may not in fact be a violation of the current "best price obligation" under UMIR if differences in transaction costs between the two marketplaces are taken into account. On the other hand, differences in transaction costs may in fact increase the amount of the trade-through or in fact create violations of the best price obligation even if the recorded price is the same or notionally better than prices displayed on other markets.

Currently, some marketplaces provide that certain orders are not charged a transaction fee and in other cases significant discounts from posted rates are provided to certain market participants. To provide comparability between displayed order prices, a marketplace-level solution would have to be able to either take into account differences in transaction fees between marketplaces for particular marketplace participants or utilize a standard transaction charge where an order is being routed from another marketplace. Of course, while a standardized charge would be easiest to administer, it would also remove cost as one of the factors on which marketplaces would compete for the execution of routed orders.

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

The position of RS is that the obligation of a market participant is owed to the marketplaces to which that market participant has access, either directly as a member, user or subscriber or indirectly as a "direct access client" or as a result of a jitney arrangement (between dealers acting as carrying and introducing brokers). RS does not believe that it is practical, nor desirable, to require market participants to obtain access

to all marketplaces. Presently, Policy 5.2 of UMIR recognizes the fact that a Participant may not have access to a marketplace as one of the factors to be considered in determining whether the Participant has undertaken "reasonable efforts" to comply with the best price obligation under Rule 5.2.

In order to encourage innovation and to allow marketplaces to appeal to specific niches, NI 21-101 allowed each ATS to specify a "class" of subscribers (and the form 21-101F2 specifically lists dealer, institution, or retail as examples of a class of subscribers.) If an ATS is designed specifically for institutions or retail investors then Participants should not be expected to access that particular marketplace notwithstanding that it has displayed the best price in a security.

Historically, dealers were not expected to be members of each of the exchanges in Canada. In fulfilling their best price obligations, the dealers were expected to honour the better-priced orders on the exchanges of which they were members. RS is of the view that nothing in NI 21-101 or its subsequent amendments changed those expectations.

As noted above, unless a market participant-level obligation also required market participants to have access to all marketplaces, a market participant could bypass better-priced orders on marketplaces to which it does not have access, thereby limiting the scope of trade-through protection.

(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?

RS believes that the historical basis and policy rationale for trade-through obligations (set out in its first comment) require the depth-of-book approach. If trade-through obligations are understood as a duty to the market, and if the purpose of trade-through obligations is to encourage investors to place limit orders, there is no principled basis on which to limit the obligation to the orders at the top of the book, if there are better-priced orders also in the book.

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

As part of a package of proposed amendments respecting various aspects of off-marketplace trades published in Market Integrity Notice 2005-012 – *Provisions Respecting "Off-Marketplace" Trades* (April 25, 2005), RS proposed the introduction of a "bypass marker" that would permit an order entered on a marketplace to fulfill the best price obligation or requirement to "move the market" to accommodate a pre-arranged trade or intentional cross by executing only with visible better-priced orders on other marketplaces. As such, the RS proposal has application for trading within a marketplace and between marketplaces and therefore has a broader application and utility than the "sweep order" concept used in Reg NMS.

(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?*

In the view of RS, there are essentially two viable options for the regulation of trade-throughs that occur because a particular marketplace does not provide transparency of the order book. If the trade-through obligation is imposed at the marketplace level, that marketplace would be precluded from executing the trade if the trade would occur at a price outside of the spread of the best ask price and best bid price from all marketplaces trading that particular security. If the marketplace had an electronic link to the other marketplace, the marketplace could "route" that portion of one of the orders to the other marketplace for execution with the better priced order in such an amount that would allow the balance of the order to be completed on the initial marketplace without trading through any better-priced orders on any other marketplace.

On the other hand, if the trade-through obligation is imposed at the market participant level, the market participant that trades outside the consolidated spread would have the obligation to immediately enter orders on the other marketplaces to which that market participant has access to satisfy their obligation to those better-priced orders. Institutional investors may not be in a position to "expand" the trade in this fashion to include better-priced orders to the same extent as Participants.

In either case, the obligation should be limited to visible orders.

(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?*

If the trade-through obligation is imposed at the marketplace level, the preferred solution would be to require that the better-priced orders be satisfied prior to the execution at the inferior price. This timing would limit the exposure of any dealer or client to satisfying better-priced orders. If there was sufficient volume on other marketplaces, those orders would be satisfied and the dealer or client would have received an overall better price than they would have if the order had executed at an inferior price.

If the trade-through obligation is imposed at the market participant level, the market participant may not know of the possibility of the trade-through until the execution of its order (particularly in the event that a marketplace does not provide pre-trade transparency for its orders). In such an event, the obligation could only be satisfied immediately after execution at the inferior price. To provide market participants with the best opportunity to control or limit their exposure to better-priced orders on other marketplaces, the solution should accommodate the satisfaction of the obligation immediately prior to, concurrent with and immediately after execution of the inferior-priced trade.

(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?

Trading in the marketplaces will be dynamic and despite best technological efforts there will always be a degree of latency introduced (particularly if the orders that are required to satisfy the obligation are not automatically generated either by the marketplace or the trading system of the market participant). For this reason, the amendments to UMIR proposed by RS sought to quantify the obligation by reference to the volume of the better-priced orders on other marketplaces at the time of the execution of the trade at the inferior price, rather than tying the obligation to trading with specific orders that exist on other marketplaces at the time of the execution of the trade at the inferior price. RS is concerned that the obligation could otherwise be "open ended" and that the trade of a small board lot on one marketplace could expose the market participant to an obligation to satisfy a block-sized order on another marketplace. As part of the request for comments on the proposed amendments to UMIR, RS specifically asked if the obligation should be limited to the volume of the trade at the inferior price. Such a limitation would be consistent with the trade-through requirements that existed at the exchange level prior to 2000.

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

UMIR identifies a series of "specialty" orders that are to be traded at specific times (such as Opening Orders and Market-on-Close Orders) or at prices which are not known at the time of the entry of the order on a marketplace (such as Call Market Orders and Volume-Weighted Average Price Orders) or by reference to other transactions (such as Basis Orders). RS believes that these types of orders should be exempt from the trade-through obligation, and the trade-through amendments to UMIR proposed by RS incorporate such amendments.

In the view of RS, a "special terms order" should only be exempt from the trade-through obligation if the special terms order is not otherwise capable of execution. For example, if a marketplace has an order for the sale of 1,000 shares which has been entered as an "all or none" special terms order, a trade of 2,000 shares of the same security on another marketplace at an inferior price would not be permitted since the special terms order is capable of execution with the purchase order for 2,000 shares. However, if the purchase order was itself an "all or none" special terms order, there would be no trade-through obligation as the purchase order would not be capable of trading with the sale order.

RS is concerned that the addition of "special terms" to any order not be allowed to be used as a mechanism to avoid trade-through obligations. It was for this reason that the trade-through amendments proposed by RS did not provide a blanket exemption for special terms 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?

Please see RS's response to the preceding question.

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

The policy rationale that RS has identified for the trade-through obligation would be undermined by an exemption for large block trades. Furthermore, the impact of the obligation to displace better-priced orders declines, as a percentage of the size of a block trade, as the size of the block trade increases, particularly under RS's proposal to introduce a cap on the displacement obligation. Under RS's proposed amendments, only the visible portion of better-priced orders on a marketplace would be protected by trade-through obligations if the block trade takes place within certain price parameters. This serves to promote the principle of protecting orders that add to visible liquidity for all trades, while making the displacement obligation more manageable for most trades.

(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?

Please see RS's response to the preceding question.

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

Please see RS's response to Question 16.

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

As noted above in response to Questions 16 and 22, RS has proposed to introduce a cap on the displacement obligation under which only the visible portion of better-priced orders on a marketplace would be protected by trade-through obligations if a trade takes place within certain price parameters. This serves to promote the principle of protecting orders that add to visible liquidity for all trades, while making the displacement obligation more manageable for most trades (i.e., those that occur within the price parameters).

For those trades which do <u>not</u> take place within the applicable price parameters, UMIR requires the Participant or Access person to "move the market" for the security in an orderly manner over a period of time. This involves entering orders that will trade with better-priced orders until all better-priced orders have been filled, at which point the original trade can be entered. During the period in which the Participant or Access Person is moving the market in this fashion, it is necessary to displace *new* orders that enter the trading book. In the specific case of the TSX, the Participant or Access Person is also required to fill the undisclosed portion of any "iceberg" order that becomes visible within the trading book as a result of the trading activity. RS believes that protecting the undisclosed portion of iceberg orders is appropriate in these circumstances because it is logically consistent with the obligation to fill new orders that enter the trading book, and distinguishing between new orders and non-visible orders that become visible during this process would be practically unworkable.

RS has proposed to amend UMIR to further limit this obligation to move the market over a period (and therefore to displace the undisclosed portion of any iceberg order that becomes visible during the period) to the entry of pre-arranged trades and intentional

crosses. (Trades on a marketplace other than pre-arranged trades and intentional crosses would, however, remain subject to the obligation to displace the visible portion of better-priced orders on other marketplaces.)

Therefore, RS believes that these limited circumstances in which the trade-through obligation applies to the non-visible portions of a trading book are justified and reasonable.

(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?

RS believes that the trade-through obligation will only be workable, whether imposed at the marketplace level or the market participant level, if it applies only to those orders that are immediately and automatically accessible.

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

RS's response to this question is set out in Part 4 of this comment.

(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?

Current requirements, including Rule 5.1 of UMIR and section 4.2 of National Instrument 23-101 – *Trading Rules* ("NI 23-101"), focus on the obligation of dealers to ensure the best execution of client orders. In addition, UMIR Rule 5.2 imposes a "best price" obligation on dealers and NI 23-101 specifically sets out the obligation of a dealer, when acting as agent for a client, to take reasonable steps to achieve the best price for the client.

RS believes that dealers are aware of their obligation to provide a client with best execution. However, there is concern that some dealers may have difficulties reconciling potential conflicts between the dealer's obligations to comply with requirements to provide best execution while also complying with the best price obligation. RS accepts, and expects, that the best execution of a client order may, in certain circumstances, result in a different trade than would have occurred had the dealer solely sought to obtain "best price". The best price obligation imposed by Rule 5.2 and section 4.2 of NI 23-101 is qualified by a requirement to undertake "reasonable efforts" and Part 1 of Policy 5.2 lists five factors that RS will take into consideration when determining whether the Participant has in fact made reasonable efforts. These factors include:

- the information available to the Participant from the information processor or information vendor;
- the transactions costs and other costs that would be associated with executing the trade on a marketplace;

- whether the Participant is a member, user or subscriber of the marketplace with the best price;

- whether markets outside of Canada have been considered (particularly if the principal market for the security is outside of Canada); and

- any specific client instructions regarding the timeliness of the execution of the order.

RS believes that changes in regulations could provide dealers with additional clarification of their obligations where such a conflict may exist. RS has proposed specific amendments to UMIR to clarify the dealer's obligations to provide best price by specifically differentiating between the trade-through obligation and the obligation to obtain best price when handling a client order. These proposals are presently subject of the request for comments in MIN 2005-016.

(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?*

If the trade-through obligation is imposed at the time of order entry and the obligation is imposed on marketplaces to either not execute the trade or to route to another marketplace that portion of the order that may be required to execute against better-priced orders, then locked or crossed markets would not occur.

On the other hand, if the trade-through obligation is imposed at the level of the market participant, crossed markets would be cleared by arbitrage activity by those persons with direct or indirect access to the marketplaces involved.

If the markets are locked, trades on each marketplace could continue as a better-priced order would not be traded through. Locked markets would only become a factor if priority to orders was assigned by both price and time. Existing UMIR provisions permit marketplaces to compete with differing allocation methodologies at the same price.

(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?*

RS believes that, subject to complying with the requirements of any trade-through obligations that may apply at the marketplace level, the method of trade allocation on a marketplace is a competitive business decision that should be within the control of 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?*

In Market Integrity Notice 2005-023 – *Guidance – Securities Trading on Multiple Marketplaces* (July 29, 2005) RS clarified that, under the current UMIR provisions, the relevant information for each Participant or Access Person is determined by the marketplaces to which the Participant or Access Person has access (as "access" was defined in MIN 2005-016 and also in that notice).

Under this approach, the last sale price can be determined, at the Participant or Access Person's option, with reference to either (i) the last sale price on the marketplace on which an order is entered, or (ii) subject to certain conditions, the last sale price on another marketplace to which the Participant or Access Person has access. The notice provides detailed guidance on how RS applies this approach in the case of the UMIR rules that incorporate the concept of "last sale price".

Even if trade-through obligations are enforced at the marketplace level, this solution does not mean that each market participant will have ready access to trade information from each marketplace to be able to ascertain the "last sale price" of a particular security among all of the marketplaces that trade that security.

RS believes that this flexible approach to the current UMIR provisions best achieves the policy rationale of the regulatory concept of a "last sale price" while remaining workable for Participants and Access Persons, in the absence of resort to the concept of a "principal" market for a security or an official "consolidated data display" maintained by a data consolidator.

7. Conclusion

In conclusion, RS reiterates its support for trade-through obligations that benefit investors on Canadian marketplaces.

RS also believes that it is critical that the CSA implement neutral trade-through obligations as soon as possible. Trade-throughs are occurring on Canadian marketplaces, and there is considerable regulatory uncertainty surrounding trade-through issues that require resolution.

In deciding between the market participant-level solution and the marketplace-level solution, the CSA should take into account readily-available comparative information about the direct costs of these alternatives. However, this analysis should not further delay the implementation of neutral trade-through obligations.

RS believes that, on balance, the marketplace-level solution – supplemented by a parallel obligation on market participants in connection with their trading outside Canada – will be more comprehensive, neutral and effective than the market participant-level solution.

As RS stated in its first comment, RS looks forward to working with the CSA to address the important issues relating to market structure and trade-through obligations set out in the Discussion Paper.

Yours truly,

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President & CEO