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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
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and

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October 31, 2005

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

Dear Sirs/Mesdames:

Markets Securities Inc. (“MSI”) appreciates the opportunity to submit additional comments on the Canadian Securities Administrators’ (“CSA”) Discussion Paper 23-403 – *Market Structure Developments and Trade-Through Obligations* and to provide further analysis of the evidence gathered from our trading experience to date. We trust that the CSA will view these supplemental comments as constructive inputs to their

analysis of this complex issue. We have limited our focus to responding to those questions on which we have some new information to offer.

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

RS's proposal seeks to eliminate immediately any possibility of trade-throughs occurring in Canadian equity markets, apart from some defined exemptions. This self-admittedly, pre-emptive proposal was a direct result of MSI seeking regulatory approval to operate a competitive alternative trading system. Regulatory action targeted at a specific entity is generally inappropriate, absent clear evidence of harm, but is especially so for a regulator tasked with overseeing competitive marketplaces.

The RS proposal contends that any trade-through represents a "substantial risk of material harm to retail and other investors, marketplaces and those persons having trading access to marketplaces".¹ Their contention of harm is entirely theoretical and is based on assumptions of investor perceptions and reactions.² Their insistence on an interim proposal to pre-empt the possibility of trade-throughs would ensure that no Canadian data could ever exist to validate or invalidate their claims. We consider this position to be inappropriate. Not only do we disagree with their theoretical analysis, we offer empirical evidence which demonstrates that Canadian financial markets have not experienced harm as a result of trade-throughs.

Estimation of Harm

The principal tenet of RS's thesis of harm rests on the assumption that allowing trade-throughs would result in a behavioural change on the part of disillusioned investors. Over time, the theory states, these investors will refrain from granting free options to the market if they are traded-through. In consequence, fewer limit orders will result in wider spreads, which would result in fewer market orders, and a vicious circle would ensue with very dire consequences: the "price discovery" process would be degraded to everyone's detriment.

Of course, whenever multiple marketplaces trade the same security without trade-through prohibitions, it is possible that one market will trade at an inferior price to another. Our earlier submission outlines many of the circumstances which could

¹ Market Integrity Notice No. 2005 – 016, May 12, 2005 page 3.

² "Instead, the more significant harm is found in the impact of trading-through on investors' incentives and their perception of fairness and the integrity of the market..." Comment letter dated October 20, 2005 from RS page 3 and 4.

legitimately lead to executions occurring at different prices. RS uses an example of a buyer willing to pay \$20 for a certain security but another investor sells that same security on another marketplace for \$19. However, it is not the mere existence of a price differential between the two trades that represents evidence of harm, even in the RS analysis. An anti-trade-through rule would not give the \$20 buyer price improvement, but would only require that the order be executed at \$20.

What matters for the determination of harm, in our opinion, must be what happens to the \$20 buyer's order and whether the investor is satisfied with the outcome. For the buyer at \$20 to become sufficiently disillusioned with the market to change behaviour, we must assume the buyer was not able to execute this order at \$20 or better within a reasonable time frame. This can occur only if i) the stock only traded once at \$19 and immediately rose above \$20, and ii) that investor has no ability to access the alternative market either directly or indirectly, and iii) there is absolutely no interaction (including via arbitrageurs) between the two marketplaces to keep prices in line.

Years of experience with inter-listed market activity, as well as BlockBook trading data to date, shows that marketplaces trading the same securities do not operate in isolation of each other and arbitrage does serve to keep markets in line, even when trading models are substantially different.

Given its position, access to market data and surveillance expertise, an estimation of this harm could have been made by RS. This "benefit" could then have been evaluated against the concrete costs of complying with an anti-trade-through rule to develop a cost-benefit analysis in support of their proposal. Unfortunately, no empirical analysis has been offered to date.

To trade once at \$19 and then move immediately above \$20 is a situation we see in the market from time to time, even in the absence of multiple marketplaces. They are, however, atypical events and are generally the result of very well-known supply imbalances associated with new issues, wide distributions or some other special situation. (Incidentally, this is the very type of information leakage and information asymmetry affecting trading flows which BlockBook is designed to minimize.) By examining TSX trades where a broker was required to take the TSX book up or down in order to print a cross on the tape, and then determining where the comeback market was following that print compared to just prior to the broker moving the book, a reasonable estimate of the total potential instances of this type of market reaction could be derived. Then, by multiplying this amount by various market share assumptions for the ATs such as BlockBook and ShorcanATS, RS could develop a best and worst case estimate of real trade-through harm.

For completeness and intellectual honesty, the analysis should then also apply some assumptions to reflect the benefit market participants could enjoy from having the opportunity for price improvement. The buyer at \$20 might, in fact, be very upset with a \$20 execution if he has the knowledge of a \$19 transaction elsewhere. By publishing the details of the block trade, as we do on BlockBook, the \$20 buyer has the ability to incorporate that information in his trading decisions. He may choose to let his order stand, or he may choose to cancel or change his order and gain the possibility of price improvement.

Every trade-through situation arguably represents a pricing error on the part of the traded-through investor. By denying the investor the opportunity to react to the new pricing information, an anti-trade-through rule could be argued to be designed less to protect investors and more to reduce the repricing burden on a dealer who is required to obtain best execution on the part of their client or to increase trading volumes on the exchange by forcing executions.

Further, while it is not our intention to minimize or make light of the importance of the role of the retail investor, the above analysis could very prove useful in removing retail as a “motherhood” issue and move the trade-through question to the point of informed discussion. If the RS is most concerned about harm to the retail investor, we need to know what proportion of limit orders are attributable to retail investors, presumably with direct market access as those acting through a broker would have the benefit of the broker’s professional expertise. The TSX emphasizes the diversity of the placers of limit orders on the exchange in its recent submission, including many who could be reasonably expected to have the incentive and ability to react appropriately to pricing information across different marketplaces.³

With the benefit of data available to RS through the TSX, educated assumptions could be made based on who the owners of the orders were (i.e. retail, pro, hedge fund, institutional investor) in order to assess the likelihood of them acting in time to change their mispriced order based on the price discovery in the another market. Using the analysis suggested above, RS could determine what proportion of retail orders are in fact limit orders and are placed directly in the TSX book for execution (but not crossed using the TSX’s client in-house priority rule) and then apply that percentage to the result of the overall harm for the market as a whole to determine the portion of harm, if any, to be attributed to the retail investor.

³ Comment letter dated September 19, 2005 from the TSX page 10.

One can only assume that given the amount of work that would be required to generate such a figure compared to the expected result (i.e. a very, very small percentage of volume and value traded annually), RS decided to forego the effort.

The BlockBook™ Evidence

The BlockBook trading experience, detailed in the attached execution summary, confirms that trade-throughs have not, in fact, caused harm to the market. Indeed, contrary to the conventional wisdom, we find evidence that BlockBook trades have likely added depth and liquidity to the market, as well as assisting in price discovery.

BlockBook has not yet been operating for two complete months, so the data is necessarily preliminary. However, 22 of BlockBook's 36 trades to October 19, 2005 have been trade-throughs. While the percentage of trades that were trade-throughs is higher than expected, a reasonable analysis of each instance provides no evidence of "harm".

For example, the minimum order size requirement and initial testing behaviour of traders has resulted in a clustering of multiple executions of 25,000 shares in the same security. It is clear that the real trading intention in some of these executions was for larger quantity trades. This pattern of executions, therefore, has tended to overstate the number of executions, and therefore trade-throughs, while understating the trade size. Thus, to simplistically point to the number of trade-throughs as evidence of harm, as did RS and other commentators, only reinforces the impression of a paucity of analytical thought on this subject.

Why so many trade-throughs?

Nearly 61% of the trades on BlockBook have been trade-throughs. While the absolute number is not relevant to the analysis of harm as described above, it may be instructive to examine why the percentage of trade-throughs to date has been different from the expected result. Prior to going live, it was our expectation that the trade-through experience on BlockBook would be similar to that of a large block trading system in the United States where roughly 90% of all trades have occurred within the spread. Our institutional clients had clearly expressed the view that they would most often trade within the context of the market and that the reason they would trade on BlockBook was in no way motivated by the absence of a displacement obligation.

RS contends that the number of trade-throughs is evidence of regulatory arbitrage. We strongly disagree. What follows is an examination of a number of alternative hypotheses which independently or in combination might explain these results.

Is the Canadian market naturally more prone to trade-throughs?

Given the fact that the Canadian market is less liquid than the U.S., is it possible that trade-throughs would naturally occur at a higher level than in the US experience? This would also imply that the TSX price discovery mechanism was less effective than previously thought. One way of validating this hypothesis is to review whether the BlockBook executions to date represent a higher than expected percentage of small cap or hard to trade stocks where one might expect the price for a large order to be different than for a small order, or where the TSX price discovery mechanism might be weaker.

We do not think the evidence supports this small cap/illiquid hypothesis to date. While some of the trade-throughs may be explained by the liquidity characteristics of the stock, these are relatively few. For example, none of the small cap stock traded (which on a value weighted basis represented 131% of the stocks' average daily volumes on the TSX) were trade-throughs. Further, there does not appear to be any correlation between the size of the trade relative to the average daily trading volume and the likelihood of it resulting in a trade-through. Indeed, the most difficult execution as assessed by stock liquidity (representing 289% of the average daily trading volume on the TSX) was not a trade-through: in fact was executed inside the TSX quote. These results validate the key benefit BlockBook contributes to the capital markets i.e. no market impact, but do not explain the number of trade-throughs.

Regulatory arbitrage or best execution?

In 16 of the 22 executions that were trade-throughs we estimate that the transaction cost to the investor to displace the better-priced orders on the TSX would have exceeded the benefit of the price improvement. Therefore, rather than interpreting the data as evidence of regulatory arbitrage, we believe that data may be more realistically interpreted as evidence of rational decision making in the pursuit of a fiduciary obligation for best execution.

For this analysis, we looked at the number of visible, better-priced orders at the time of execution and calculated the transaction cost to the investor to displace those orders. For costs, we used a very conservative \$50 per trade to represent only the extra costs of settling more than one trade. We know that these costs vary greatly among institutions and can exceed \$100 per trade in some cases. In addition, we did not include any expected differential in commission charges, although this may also contribute to higher transaction costs, given our commission rate of \$0.02 per share and the average institutional commission rate of \$0.03 - \$0.05 per share. Finally, the labour costs associated with multiple trade-tickets and the potential for error in trade size calculations are other potential sources of additional costs/risks associated with a displacement requirement, which we have not included. We further compounded the

conservative nature of the analysis by using only the best price to calculate trade-through amount. Where there was more than one order traded through, the prices would have been closer to the execution price on BlockBook, thus reducing the total dollar amount traded-through.

In 16 out of the 22 instances of trade-throughs, the execution price, after transaction costs, had the investor been obliged to displace the “better-priced” orders on the TSX, would have been inferior to the execution price achieved on BlockBook. This analysis supports the conclusion that investors are using BlockBook to fulfill their fiduciary obligation to achieve best-execution, rather than exploiting a regulatory loophole.

Further, we would argue that these 16 instances should not even be classified as trade-throughs under the existing rules. Rule 5.2 (3) states “...*the Participant may take into account any transaction fees...*” when complying with the best price rule.

We note that RS emphasizes this point in its June 15, 2005 submission on Concept Paper 23-402 – Best Execution and Soft Dollar Arrangements when it stated: “*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 sought to obtain only “best price”. The best price obligation ...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 in fact the participant has made reasonable efforts. These factors include: ...*

- *The transaction costs and other costs that would be associated with executing the trade on a marketplace: ...”*

If these 16 instances are eliminated, the results to date are much less alarming and a more realistic assessment of the actual experience. The percentage of trade-throughs relative to executions drops to 17% of trades. Moreover, if a less conservative analysis were done, one may in fact reasonably reach the conclusion that virtually all of the executions would not be classified as trade-throughs. We find the absence of any reference to these facts a notable deficiency in the RS analysis.

Another possible (but more prosaic) explanation: human error.

Traders have not had the experience of placing orders on multiple markets in Canada and have been learning how to manage their orders on BlockBook in the absence of market integration. Sometimes trade-throughs occurred as a result of the TSX price moving at the point of execution. Slightly more than one half of all trade-throughs were by less than \$0.03. Many of these may have been unintended. Trade-throughs have also occurred as a result of subscribers becoming comfortable with BlockBook work

flow requirements. For example, we have heard anecdotally of traders “forgetting” about orders in BlockBook or mis-applying order features. As subscribers become comfortable with BlockBook and multiple markets in general, we expect that the percentage of executions which are trade-throughs will likely decline.

Evidence of “harm”?

Returning to the methodology we proposed above, can we glean from these preliminary data whether the trade-throughs to date have harmed the limit order placers on the TSX? That is, have those better-priced orders been left stranded without the possibility of execution within a reasonable time-frame?

Of the 13 executions with a trade-through amount of \$0.03 or less we do see the traded-through orders being executed and prices on the TSX reacting, however it is difficult to make a case for causality: this activity could be explained as normal trading activity, rather than as a reaction to the BlockBook trades.

Of the 9 executions with a trade-through amount that was greater than \$0.03, the data may be more meaningful. In these cases, BlockBook trading data clearly indicates that the visible book on the TSX at the time of trade-through has consistently been displaced by market participants - whether or not the BlockBook trader had a displacement obligation. In addition, the average time to displacement was 81 seconds.

In only one instance did the TSX market not move as a result of the BlockBook trade and in all but one instance the visible book displaced was larger than the visible better-priced orders at the time of the trade-through. While client confidentiality prevents us from going into greater detail in this public submission, the vast majority of trade-throughs that occurred on BlockBook had no displacement requirement, yet displacement occurred naturally and for amounts that were generally larger than any required displacement would have commanded.

How does the TSX order book move in response to executions on BlockBook?

The evidence of the TSX order book reaction to BlockBook executions is evidence of efficient markets responding to new information. We believe that a market structure of full post-trade disclosure, which allows investors the opportunity to adjust their trading strategies for all information, including large trades and potentially achieve price improvement, is a better way to promote the objective of competition among orders than an anti-trade-through rule.

In addition to looking at the speed and size of the TSX order book reaction separately, we find that there appears to be a direct relationship between the amount of the trade-through and the TSX order book reaction. If you multiply the speed of the market reaction (“market efficiency lag”) by the share amount of the resulting TSX executions, one can create a combined measure of the TSX market reaction (labeled Combined Market Efficiency on the attached chart).

While the 9 executions with a traded-through amount greater than \$0.03 is an admittedly small sample set from which to draw conclusions, there is at least some evidence that the greater the traded-through amount, the stronger the likelihood of the TSX orders being executed. This result also makes intuitive sense: the greater the trade-through amount, the greater the profit opportunity as a result of the mis-priced order and the greater the likelihood of someone acting. We also note that in one case an order was cancelled, perhaps indicating that the investor was taking advantage of the pricing information from BlockBook. We believe that the vibrancy of the TSX order book reaction in these cases represents the best evidence of the ability of market participants to make the necessary adjustments and benefit from the price discovery occurring on BlockBook.

What makes this data really remarkable is not only that it reconfirms the fact that markets are efficient and arbitrage is a powerful positive force, but that this market efficiency is evident despite limited information dispersion of BlockBook information to the broader market. We all know that the more information that is available to a market, the greater the efficiency of the market. While MSI has contracted with the TSX Datalinx to disseminate execution data, to date no third party vendor, aside from Reuters (with whom we have a direct relationship), has published BlockBook data. In addition, the data available through Reuters is unconsolidated, which limits its usefulness. Given that most traders must ration screen space to only the most regularly used information sources and that not all market participants subscribe to Reuters, the reality is the vast majority of Canadian equity market participants are not yet aware of executions on BlockBook.

Thus, even with only a small portion of the market aware of BlockBook activity, the overall market appears to be efficient. The greatest harm here, in our view, is not that trade-throughs occurred, but that a large segment of the market has not been able to benefit from BlockBook price discovery. Further, it is our strongly held belief that, as more data vendors publish BlockBook execution information and a consolidated data source becomes available, the markets will become more efficient and adjustment lags will become shorter and shorter.

Impact of RS Proposal on BlockBook

It has been suggested by RS that imposing the same displacement obligation on Access Persons as currently exists for dealers would not create any hardship for MSI or our clients. Two arguments are used to support this position: 1) the pegged order type on BlockBook can be easily used to prevent trade-throughs, so why don't all subscribers use that feature? and 2) if dealers are currently able to fulfill their trade-through obligations when trading on BlockBook, why can't institutions?

Pegged Orders

BlockBook offers an order type which allows the price of the order to fluctuate with the current quote for that security on the TSX. This is known as a pegged order. Traders can peg their order price to the TSX bid, mid or ask and can indicate a positive or negative off-set to that benchmark. For example, a buyer might peg his order to the bid, less a couple of cents to place him in good position for execution. Depending on the characteristics of the stock, therefore, a pegged order can be used to prevent trading through the TSX quote. For example, an order pegged to the mid would never trade outside the quote.

While this feature can be used to prevent trade-throughs currently, as soon as another market (e.g. CNQ) starts trading the same securities, this feature would no longer be effective in preventing trade-throughs on all markets.

More importantly in the short-term, trade-through protection was not the intended purpose of the pegged order type. Pegged orders were designed to allow traders the ability to leave orders in the market while automatically updating the price for changes in the primary market. The advantages to the trader are the workflow benefits of not having to constantly adjust order prices for every change in the market and the ability to passively trade along with the market in those circumstances where the trading benchmark is less aggressive e.g. VWAP.

It was for these reasons that we designed the signaling features of BlockBook to treat pegged orders differently than limit price orders. Because pegged orders were assumed to be price-takers or traders with no interest in price negotiation, the signaling mechanism which alerts traders to orders that are potentially matching and indicates whether parties are moving ignores pegged orders. To be clear, pegged orders have equal standing with limit price orders as far as execution eligibility which is based on price/time priority, however, they do not trigger the price negotiation signaling. The rationale for this differential treatment is straight forward: if pegged orders were eligible for the signaling mechanism, every time the TSX quote moved a message would go to the market indicating that an order had moved its price, implying that a

trader was initiating an active negotiation. Obviously, this would be a false signal and the frequency of this occurrence would be detrimental to the integrity of the signaling mechanism as a whole.

Without a meaningful signaling mechanism that provides traders with sufficient information to meet on both price and volume, one of the core sources of value the BlockBook is providing would be eliminated. The early evidence we have to date suggests that the signaling mechanism is very effective (25% of orders are entered in response to a signal; the probability of an execution for every order entered has been close to 5%, but that rises dramatically to over 20% if a potential match/negotiation signal is created).

There is ample evidence of crossing systems, which provided no opportunity for price negotiation but relied on the TSX price discovery mechanism, failing in Canada (e.g. POSIT, Canadian Call, Lynxx). Our clients have told us that they want control over their execution price and want to maintain the opportunity for price improvement. This is part of the innovation that BlockBook has brought to the market. To date only 12% of the orders entered have been pegged orders and only 1 pegged order has resulted in an execution, showing the strong preference of our subscribers for limit orders. While we may over time find ways to incorporate signaling into the pegged order type, this is not present at the moment.

To suggest that constraining the functionality of BlockBook to the pegged order feature would not have an impact on the viability of our marketplace demonstrates a lack of understanding about the particular needs and constraints of traders of large positions and the positive innovation the BlockBook system is bringing to the market. It also implies that competitive marketplaces are only to be tolerated if they acknowledge the supremacy of a public limit order book price discovery mechanism. This is a clear limitation to the scope of innovative developments and ignores the legitimate trading needs of large size investors; whether buy-side or sell-side.

Current dealer compliance with best price rule

Presently, the four dealers who are subscribers to BlockBook have three options to ensure compliance with the existing rules. They can prevent trade-throughs by using the pegged order feature, they can utilize an existing exemption for a Special Terms order, or they can displace the visible, better-priced orders on the TSX immediately following the execution at a trade-through price on BlockBook. Each of these options has limitations and can best be described as “work arounds” in the current context.

The constraining nature of pegged orders and the apparent lower probability of execution associated with them have already been discussed above. Similarly, the two exemptions currently eligible for use on BlockBook (all-or-none and minimum fill) would also reduce the likelihood of executions occurring by adding a liquidity constraint beyond the already high minimum order size. Plus, dealers rarely receive client orders with minimum fill or all or none constraints, reducing the number of instances in which these exemptions could be used.⁴

The after-the-fact displacement option has only been used once to date. The execution was the result of a trader error and while the trader did ultimately fulfill the displacement obligation it was not in a very timely manner and required pro-active measures on the part of MSI and RS. This example, while isolated, serves to demonstrate the risks associated with this mechanism. The trader must be monitoring both markets for both price and an estimate of the potential displacement liability. Once an execution on BlockBook occurs, the trader must quickly create an order that reflects the right share amount at that moment and transmit it to the TSX.

It is clear that if this option for compliance is difficult to manage for a sell-side trader, it would be impossible for a buy-side trader. In addition to the workflow and displacement liability monitoring requirements with which the sell-side trader has more experience, the buy-side trader has less flexibility in execution amounts.

Institutional trade authorization procedures constrain the buy-side trader to a specific amount to purchase or sell. To maintain compliance with investment guidelines and/or prospectus disclosure, the trader would be prohibited from buying in excess of the amount determined by the portfolio manager. This constraint is even more serious when selling: to sell more than the amount determined by the portfolio manager would risk selling in excess of the position held (i.e. selling short). Most institutions are prohibited from selling short. This is in direct contrast to the sell-side trader who can use his firm's capital to execute the displacement orders and a trading account to sell the excess or buy the shortfall that may result.

The buy-side trader would therefore need to adjust the amount of the BlockBook order to leave room to execute the displacement obligation. It is easy to see how this

⁴ In its initial discussions with RS and the OSC, Markets Securities Inc proposed that all orders on BlockBook ought to be eligible for an exemption from the trade-through rule. The minimum order size of 25,000 shares functions in exactly the same manner as the minimum fill or all or none constraint which currently benefits from an exemption on the TSX. These Special Terms orders have no standing in the TSX order book as, due to their constraints, they cannot match with the other orders on the normal order book. We continue to believe that that same treatment should be afforded to all BlockBook orders which, due to their constraints, cannot match with the other orders in the normal TSX order book.

additional burden of estimation, order size adjustment and order monitoring would introduce enough friction to reduce the number of orders that would have otherwise been submitted to BlockBook. Further, the risks associated with compliance may be considered too great for some institutions and prevent their use of BlockBook altogether.

MSI is currently working on an automated solution for displacement which would alleviate the burden of compliance for our dealer clients. Necessarily, this solution requires the ability to generate orders and send them to the TSX. All of the issues associated with market integration (who sends the orders, financial responsibility, order format, counterparty, settlement, etc.) are required to be addressed in offering this solution, which is why it was impossible to have it in place prior to launch. We expect to have this solution in place within 6 months.

While an automated solution should facilitate compliance for our dealer clients, it does not address the fundamental differences between buy-side traders and sell-side traders. Buy-side traders would still need to adjust their order sizes on BlockBook to leave room for the displacement orders. Thus, the most probable result of a displacement obligation being imposed on buy-side traders, as is proposed in the RS proposal, would be to remove the possibility of a direct market access solution for block trades. Institutions would only execute block trades through dealers in the upstairs market, and let them manage the displacement obligation.

This result would seriously compromise the viability of BlockBook. More importantly, however, this result would have serious negative consequences for the market as a whole. Institutions would have no means of controlling their large executions directly, thus preventing the information leakage associated with the upstairs market that we all acknowledge is detrimental to execution quality. RS highlighted the extent of market concern around frontrunning and information leakage in its report on the subject earlier this year. *“Both sell-side and buy-side firms believe that there is serious information leakage about pending transactions and large orders, within both sell-side and buy-side firms”*.⁵

For RS to have identified the issue of frontrunning as being a key concern for market integrity and yet not to have considered that this interim proposal could have a negative impact on the single most positive development in this regard, namely BlockBook, is extremely disappointing. Further, to highlight the number of block trades currently executed in the upstairs market and imply that if these were to migrate to the

⁵ A Review of Frontrunning and Client Priority Issues in Canadian Equity Marketplaces, Market Regulation Services Inc., March 2005.

BlockBook platform the only impact to the market would be harmful as a result of a potential higher incidence of trade-throughs, with no mention of compensating benefits⁶, reduces the credibility of the rest of their analysis. Plus, we would have hoped that RS would have exercised as much diligence in examining whether brokers were in fact complying with their best execution responsibilities when on more than 100 separate occasions during this same period BlockBook had better-priced orders than trades on the TSX. This fact, however, is not mentioned in the RS analysis.

We believe that the continued forceful advocacy of this proposal and the use of inflammatory language have damaged RS's credibility as an impartial enforcer of the existing rules and policies. To attempt to introduce a dramatically new regulatory requirement (especially one that had already been rejected by the market as needing more analysis) for immediate implementation, without notice or consultation, as RS did in May, is akin to the home team changing the rules of play at opening kick-off. But then, to continue to campaign for this proposal despite well-founded concerns expressed by many affected parties borders on irresponsibility.

We believe the apparently targeted nature of these actions towards our marketplace has resulted in damage to our reputation, and, more importantly, to the policy objective of competitive marketplaces in general. RS's actions and statements in this area have resulted in a climate of regulatory uncertainty which benefits no one but those happy with the status quo.

CNQ/TSXV Trade-Throughs

RS concludes that the instances of trade-throughs between CNQ and TSXV were "inadvertent"⁷, leaving the impression of no regulatory concern. We are surprised at the differing conclusions regarding the impact trade-throughs on these markets and our own. It is inconsistent to assert that in one instance there is a risk of significant harm as a result of damage to the perception of fairness and in the other instance there is not.

We note that the explanation given was the fact that the same securities had different ticker symbols. This fact also surprises us. The Universal Market Integrity Rules are very clear on this point. Part 10.15 – Assignment of Identifiers and Symbols – states that each security shall be assigned a unique symbol for trading purposes and that, absent an agreement to the contrary, the TSX shall do the assigning.

⁶ Comment letter dated October 20, 2005 from RS, page 4

⁷ RS comment letter, October 20, 2005 page 5.

As a new marketplace endeavouring to comply with the regulations as set out, we do not understand how this circumstance can be permitted to occur. To allow a direct contravention of a rule in the first place, and then to allow it to continue in the face of real harm to the market⁸, is inexplicable. Surely market integrity would be better served by a consistent application of existing rules and policies.

Question #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?

There is a real risk in creating a burdensome compliance environment by trying to be marketplace neutral in all instances. In this circumstance, we support the notion of a primary market being selected as a single source for a defined last sale price which would be used for compliance with various regulations. The benefits of simplicity far outweigh the costs of not allowing every market to contribute to this input. Further, it eliminates the need to determine if the price on certain markets is appropriate on an ad hoc basis. For example, the last sale price on BlockBook will likely be much older than the last sale price on the TSX, given the differences in our markets. We would argue, therefore that to use such a price would not be reflective of the policy interests incorporated in the rules using the last sale price.

Conclusion

No one knows for sure whether anti-trade-through rules would help or harm the Canadian capital markets. We are not persuaded by the theoretical arguments of harm, although we do acknowledge their strong support by many participants. We have presented some interesting, albeit preliminary, evidence to support the arguments suggesting that anti-trade-through rules are unnecessary. We welcome the opportunity to continue this analysis and to benefit from the input of others who may have other insights or differing interpretations.

However, everyone agrees, to a greater or lesser extent, that anti-trade-through rules do place barriers in the way of competitive marketplaces and innovation. In our previous submission we described the negative consequences to competitive markets as a result of an anti-trade-through rule. While commentators will have differing views on the degree of negative impact, one thing is clear: the more stringent the rule, the greater the potential negative impact.

Inter-market order routing does not exist yet in Canada, and the burden on a new marketplace to create this type of facility would be prohibitive. Even to the extent that

⁸ Canaccord Capital Corporation comment letter, October 18, 2005, page 2.

inter-market order routing develops, the burden on a new marketplace to achieve integration as a prerequisite for operation would prove prohibitive for all but those who have the financial wherewithal and market clout to ensure that integration occurred, and occurred within a reasonable time frame. This would effectively limit the potential for true market innovation.

We have the perfect evidence of this outcome in Canada in the lack of new marketplaces while the market integration requirement existed. Thus, even if one acknowledges the theoretical benefits of an anti-trade-through rule, there is a real potential to do more harm than good. We note that this issue was a serious concern for the SEC, and contributed to the less onerous “top of book” end result that they appear set to implement.⁹ In addition, we note the extended implementation period the SEC has proposed, despite the well-developed market linkages and order routing technology that already exists there.

We have designed our marketplace to be completely in compliance with existing rules and are committed to making the necessary changes to accommodate new rules, as appropriate. While we strenuously object to the RS proposal and especially its insistence on immediate implementation, we have tried to be a constructive contributor to this important debate.

We thank the CSA for its leadership on the issue and for your willingness to examine the evidence in an impartial and balanced manner. We would be happy to continue to participate in whatever rule formulation results from this analysis and will continue to monitor the results of our marketplace for evidence that might provide some insight.

Yours truly,

Judith Robertson
President and CEO

⁹ “We are not recommending adoption of the Voluntary Depth Alternative, which would have required quotes voluntarily displayed below the top of the book to be protected. Many commentators believed that enhanced book interaction would likely result under the Market BBO Alternative, but with fewer of the costs and drawbacks associated with the Voluntary Depth Alternative. For example, many believed that the Voluntary Depth Alternative could be significantly more difficult and costly to implement, and that it put too much emphasis on competition among orders to the exclusion of competition among markets.” Opening Statement before Open Meeting regarding Regulation NMS, Annette L. Nazareth, Director, Division of Market Regulation, U.S. Securities and Exchange Commission, April 6, 2005.



BlockBook Execution Summary- Sorted by Trade-Through Amount

DATE	Execution Time	Symbol	News/Event	Price	Quantity	Value	TSX Visible Book		TSX Visible Size		Execution vs. TSX Book	Trade Through Amount (1)	Total Better Vis. Orders (2)	# of Better Vis. Orders (3)	Opp. Cost/ Price Impr. (4)	Net opp. cost after fees (5)	Ratio trade size / visible book (6)	Obligation Y/N	Time of TSX Order Book Reaction Time (7)	TSX Order Book Reaction (8)	Comeback Market (9)	Market Efficiency Lag (10)	Combined Market Efficiency (11)	Market Cap	Average Daily Volume	% Avg Daily Volume	
							Bid	Offer	Bid	Offer																	
1	10/18/05	1:50:15 PM TCW		40.85	34,700	1,417,495	40.81	40.84	1,900	500	T-THRU	0.01	500	3	5	-145	69	N	1:51:56 PM	100 at 4.81	40.81/40.83	01:41.0	0.117	MID	233,958	15%	
2	8/23/05	10:25:16 AM RCI.NV.B		44.19	32,000	1,414,080	44.17	44.18	2,400	900	T-THRU	0.01	900	1	9	-41	36	N	10:25:50 AM	900 @ 44.18	44.17/44.20	00:34.0	0.354	LARGE	593,503	5%	
3	10/18/05	1:46:12 PM TCW		40.85	25,000	1,021,250	40.81	40.84	1,800	1,300	T-THRU	0.01	1,300	4	13	-187	19	N	1:46:21 PM	800 cxl, 100 at 40.84	40.81/40.84	00:09.0	0.094	MID	233,958	11%	
4	10/4/05	3:01:51 PM DTC		7.65	75,000	573,750	7.66	7.67	400	2,200	T-THRU	0.01	400	1	4	-46	188	N	3:03:37 PM	300at 7.66	7.66/7.67	01:46.0	0.368	MID	1,135,409	7%	
5	10/4/05	3:54:56 PM DTC		7.65	50,000	382,500	7.66	7.68	500	500	T-THRU	0.01	500	1	5	-45	100	N	3:55:11 PM	300 at 7.68	7.66/7.68	00:15.0	0.052	MID	1,135,409	4%	
6	10/4/05	2:59:21 PM DTC		7.65	25,000	191,250	7.66	7.67	600	2,100	T-THRU	0.01	600	1	6	-44	42	N	2:59:48 PM	2200 at 7.66	7.66/7.67	00:27.0	0.069	MID	1,135,409	2%	
7	10/4/05	3:52:26 PM DTC		7.65	25,000	191,250	7.66	7.68	1,000	4,200	T-THRU	0.01	1,000	1	10	-40	25	N	3:52:58 PM	6300 at 7.66	7.66/7.67	00:32.0	2.333	MID	1,135,409	2%	
8	10/4/05	3:04:58 PM DTC		7.65	50,000	382,500	7.66	7.67	1,200	600	T-THRU	0.01	1,200	2	12	-88	42	N	3:05:00 PM	300 at 7.67	7.66/7.67	00:02.0	0.007	MID	1,135,409	4%	
9	10/4/05	3:09:03 PM DTC		7.65	50,000	382,500	7.66	7.67	1,200	6,300	T-THRU	0.01	1,200	1	12	-38	42	N	3:09:25 PM	5200 at 7.66	7.65/7.67	00:22.0	1.324	MID	1,135,409	4%	
10	9/13/05	12:49:23 PM GNA		6.10	25,000	152,500	6.05	6.08	1,400	500	T-THRU	0.02	1,800	2	10	-90	14	N	12:50:51 PM	500 at 6.08	6.05/6.09	01:28.0	0.509	MID	292,997	9%	
11	9/28/05	12:59:02 PM VN	Yes	36.02	50,000	1,801,000	35.99	36.00	1,800	13,100	T-THRU	0.02	14,300	3	262	112	3	Y	1:04:41 PM	3000at 36.00	14,300 at 35.9	35.95/36.00	05:39.0	75.726	MID	951,889	5%
12	9/21/05	12:06:09 PM ANP		15.62	25,000	390,500	15.56	15.59	200	500	T-THRU	0.03	1,300	2	15	-85	19	N	12:08:12 PM	500 at 15.59	15.56/15.61	02:03.0	0.712	MID	129,572	19%	
13	10/4/05	3:59:50 PM DTC		7.65	25,000	191,250	7.68	7.70	4,000	20,900	T-THRU	0.03	4,000	2	120	20	6	N	3:59:53 PM	1300 at 7.68	7.68/7.70	00:03.0	0.045	MID	1,135,409	2%	
14	9/21/05	12:09:09 PM ANP		15.62	25,000	390,500	15.55	15.56	1,700	400	T-THRU	0.06	1,100	2	24	-76	23	N	12:10:11 PM	44 at 15.55	15.55/15.60	01:02.0	0.032	MID	129,572	19%	
15	10/13/05	11:04:52 AM BCE		30.20	25,000	755,000	30.13	30.14	200	300	T-THRU	0.06	7,200	10	432	-68	3	N	11:05:16 AM	22,400 ar 30.14-30.17	30.18/30.22	00:24.0	6.222	LARGE	3,577,408	1%	
16	10/13/05	10:03:06 AM BCE		30.50	25,000	762,500	30.43	30.44	300	2,500	T-THRU	0.06	9,200	9	552	102	3	N	10:03:42 AM	23,100 at 30.41-30.45	30.41/30.45	00:36.0	9.625	LARGE	3,577,408	1%	
17	9/13/05	12:42:26 PM GNA		6.10	50,000	305,000	6.03	6.04	1,400	300	T-THRU	0.06	5,500	9	18	-432	9	N	12:44:40 PM	300 at 6.04	6.03/6.07	02:14.0	0.000	MID	292,997	17%	
18	9/13/05	12:39:56 PM GNA		6.10	25,000	152,500	6.03	6.04	1,400	1,200	T-THRU	0.06	9,100	10	72	-428	3	N	12:42:18 PM	900 cxl, 300 at 6.04	6.03/6.07	02:22.0	1.479	MID	292,997	9%	
19	10/13/05	10:06:06 AM BCE		30.50	25,000	762,500	30.41	30.43	600	1,300	T-THRU	0.07	5,800	6	406	106	4	N	10:06:23 AM	16,000 at 30.43-30.45	30.45/30.48	00:17.0	3.148	LARGE	3,577,408	1%	
20	10/13/05	10:52:49 AM BCE		30.27	25,000	756,750	30.17	30.19	200	2,500	T-THRU	0.08	11,800	10	944	444	2	N	10:53:02 AM	19,500 at 30.19-30.21	30.21/30.22	00:13.0	2.934	LARGE	3,577,408	1%	
21	9/13/05	12:08:35 PM IQW/SV		22.85	25,000	571,250	22.75	22.76	7600	3,100	T-THRU	0.09	4,600	9	279	-171	5	N	12:09:22 PM	5,400 at 22.76-22.80	22.77/22.83	00:47.0	2.938	MID	257,326	10%	
22	10/12/05	12:47:54 PM FTS	Yes	24.87	25,000	621,750	25.15	25.18	900	200	T-THRU	0.28	12,500	19	3500	2550	2.0	N	12:48:51 PM	22,500 at 25.15-24.90	24.90/25.15	00:57.0	14.844	MID	251,046	10%	
23	8/22/05	2:35:37 PM NNO		3.21	100,000	321,000	3.20	3.21	3,000	5,700	MID MKT												SMALL	503,064	20%		
24	8/22/05	2:39:40 PM BGO		2.86	81,000	231,660	2.85	2.86	10,600	43,800	MID MKT												MID	1,920,062	4%		
25	8/23/05	9:59:35 AM RCI.NV.B		44.19	25,000	1,104,750	44.18	44.19	2,400	1,700	MID MKT												LARGE	593,503	4%		
26	8/30/05	1:35:15 PM HBG		25.21	25,000	630,250	25.09	25.23	500	200	INSIDE												SMALL	8,648	289%		
27	8/31/05	11:31:08 AM COM		8.54	100,000	854,000	8.52	8.56	1,000	300	MID MKT												SMALL	115,502	87%		
28	8/31/05	11:31:48 AM IMX		10.86	25,000	271,500	10.85	10.88	500	800	MID MKT												SMALL	74,084	34%		
29	9/7/05	1:28:43 AM A		5.40	100,000	540,000	5.39	5.40	4,500	5,500	MID MKT												MID	1,154,284	9%		
30	9/7/05	1:31:13 PM A		5.40	25,000	135,000	5.39	5.40	6,400	12,700	MID MKT												MID	1,154,284	2%		
31	9/13/05	12:41:12 PM IQW/SV		22.85	25,000	571,250	22.81	22.85	3,100	700	INSIDE												MID	257,326	10%		
32	9/28/05	10:45:23 AM BCE		31.85	25,000	796,250	31.85	31.86	6,000	3,000	MID MKT												LARGE	3,508,960	1%		
33	9/28/05	10:47:53 AM BCE		31.85	50,000	1,592,500	31.85	31.87	3,900	2,500	INSIDE												LARGE	3,508,960	1%		
34	9/28/05	10:49:55 AM BCE		31.85	50,000	1,592,500	31.85	31.87	4,300	2,900	INSIDE												LARGE	3,508,960	1%		
35	9/28/05	12:51:42 PM VN		36.05	50,000	1,802,500	36.03	36.05	200	500	INSIDE												MID	951,889	5%		
36	10/13/05	11:07:22 AM BCE		30.20	25,000	755,000	30.18	30.22	2,500	2,100	MID MKT												LARGE	3,577,408	1%		

Average 40,214 687,993 4,355 305 60 30 01:05.1 5.588 17%

- (1) Difference in BlockBook execution price and the best priced order on the TSX
- (2) The total volume of better priced orders traded through (not just top of book)
- (3) The number of orders making up the total better priced orders
- (4) (1) X (2) = amount of price improvement
- (5) (4) - ((3) X 50) Total price improvement benefit- cost to achieve price improvement. Assumes settlement cost of \$50 per trade.
- (6) Ratio of the size of the BlockBook execution to the amount of better priced orders on the TSX
- (7) The time the TSX order book moved following a BlockBook trade or in response to a BlockBook trade
- (8) details TSX book activity. A cancelled order could be interpreted as a user reacting to BlockBook execution.
- (9) where the TSX book settled after a trade on BlockBook and subsequent reaction.
- (10) (7) - execution time. How long did it take for the market to react.
- (11) (7) * (8 shares only) = How long did it take for the market to react multiplied by the share volume of the market reaction to create a combined measure of market efficiency.