INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÉRES

October 12, 2006

Alberta Securities Commission
British Columbia Securities Commission
New Brunswick Securities Commission
Registrar of Securities, Northwest Territories
Registrar of Securities, Government of Nunavut
Prince Edward Island Securities Office
Registrar of Securities, Government of Yukon
c/o Mr. John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West, Suite 1900, Box 55
Toronto, Ontario M5H 3S8
E-mail: jstevenson@osc.gov.on.ca

L' Autorité des marchés financiers (Québec)
Manitoba Securities Commission
Securities Commission of Newfoundland and Labrador
Nova Scotia Securities Commission
Ontario Securities Commission (OSC)
Saskatchewan Financial Services Commission

a/s Madame Anne-Marie Beaudoin, Directrice du secrétariat
Autorité des marchés financiers
800, square Victoria, 22e étage
Montréal, Québec H4Z 1G3
E-mail:consultation-en-cours@lautorite.qc.ca

Dear Sirs and Madams:

Re: IIAC Comments on Debt Markets Transparency, National Instruments (NIs) 21-101 – *Marketplace* Operation and 23-101 – *Trading Rules* (NI 23-101)), and Companion Policies (CPs) 21-101CP and 23-101CP (the Alternative Trading System (ATS) Rules)

The Investment Industry Association of Canada (IIAC)[1] is pleased to reply to the Canadian Securities Administrators' (CSA's) July 14, 2006 request for comments on proposed amendments to the ATS rules with respect to debt market transparency. The objectives of the amendments – ensuring that trading is fair and efficient, improving price discovery, decreasing execution costs, enhancing integrity and providing investor choice – are worthy goals that IIAC supports. The CSA policy decision in 2003 to allow market forces to develop transparency in the Canadian market incrementally has achieved more accessible real-time market prices on more debt securities leading to, and consistent with, well-functioning, innovative and liquid markets.

IIAC believes that the reasons for the 2003 decision remain valid and are even more sound today. Also, debt market transparency needed then, as it needs now, a solution different from that used in the equity markets. Equity markets are based on an exchange-based structure in contrast to the principal-based, quote-driven structure of the bond market where institutional investors – for example, large pension plans – often rely on the ability to maintain the anonymity of their transactions and the willingness of others to make a market. **We believe that the CSA should focus on optimal rather than maximum transparency on the principle that price transparency is only a desirable goal to the extent that it does not harm liquidity**, in light of:

(i) clear evidence of market-driven improvements in transparency since 2003 in response to investor interest, despite the exemption for government debt and limited mandated corporate transparency, as well as every indication from new ATSs entering the market and new technology solutions that competition will generate further improvements

(ii) no identified systemic transparency problems in the institutional market, which is largely self-policing (according to the OSC/Investment Dealers Association of Canada (IDA)-commissioned 2002 study on transparency) and work in the retail market expected to be undertaken by the IDA and/or other self-regulatory organizations (SROs)

(iii) risks to market behaviour and information accessibility if regulators do not, as the U.K. Financial Services Authority (FSA) notes, exercise "extreme caution" in mandating greater transparency

(iv) ongoing work on transparency at the institutional and retail level – from which the Canadian marketplace may benefit – by the European Commission, the European Union, the FSA and, possibly, the recently struck U.S. Committee on Capital Markets Regulation and price transparency analyses that may be undertaken assuming the National Association of Securities Dealers (NASD) releases Trade Reporting and Compliance Engine (TRACE) data as expected.

We recommend, for the **institutional debt market:**

1. a deferral of further mandated transparency for corporate debt and
2. continued exemption until 2011 for government debt.

This said, we believe that the institutional and retail transparency regime should reflect the overall marketplace, that is, brokers, inter-dealer brokers (IDBs) and ATS markets, and only apply to firms that have market share of at least a half of one per cent of trade volumes.

With respect to **retail debt market** transparency, we recognize that price is an important factor in best execution and that direct retail involvement in government and corporate debt markets is expected to increase. For these reasons, we support and will contribute to consultations regarding educational and appropriate regulatory measures to promote what is required for retail investors investing directly in the debt market, including transparency in terms of content and access methods. We believe that the review of issues relating to transparency for retail investors should be undertaken by the IDA in the context not only of best execution, but also of retail issues more broadly, to identify whether it is transparency or other concerns that impede retail participation in bond markets.

Our detailed comments are attached, prepared including input from not only dealers, but also IDBs, ATSs and buyside representatives who may provide additional views directly. We look forward to further discussions on the important issue of transparency in the debt markets and would be pleased to discuss these issues with you at your convenience. In the meantime, please contact Barbara Amsden ((416) 687-5476; bamsden@iiac.ca) or Jack Rando ((416) 687-5477; jrando@iiac.ca) if you have any questions regarding our submission.

Yours truly,

Ian C. W. Russell, FCSI
President and CEO

Greg Smith
Chair, Debt Markets Committee

[1] On April 1, 2006, the Investment Dealers Association of Canada (IDA) legally divided into a self-regulatory organization (SRO) and IIAC – the industry association. The Association represents the position of the Canadian investment industry on regulatory and public policy issues. Its mandate is to promote efficient, fair and competitive capital markets for Canada while helping its member firms succeed in the industry.

INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÉRES

INVESTMENT INDUSTRY ASSOCIATION OF CANADA ("IIAC") DETAILED COMMENTS ON TRANSPARENCY AND RESPONSES TO CSA QUESTIONS

IIAC RECOMMENDATIONS

We believe that the Canadian Securities Regulators ("CSA") should focus on optimal rather than maximum transparency on the principle that price transparency is only a desirable goal to the extent that it does not harm liquidity. This is due to:

(i) clear evidence of market-driven improvements in transparency since 2003 in response to investor interest, despite the exemption for government debt and limited mandated corporate transparency, as well as every indication from new ATSs entering the market and new technology solutions that competition will generate further improvements

(ii) no identified systemic transparency problems in the institutional market, which is largely self-policing (according to the Ontario Securities Commission ("OSC")/Investment Dealers Association of Canada (IDA)-commissioned 2002 study on transparency) and work the retail market expected to be undertaken by the IDA and/or other self-regulatory organizations (SROs)

(iii) risks to market behaviour and information accessibility if regulators do not, as the U.K. Financial Services Authority (FSA) notes, exercise "extreme caution" in mandating greater transparency

(iv) ongoing work on transparency at the institutional and retail level – from which the Canadian marketplace may benefit – by the European Commission, the European Union, the FSA and, possibly, the recently struck U.S. Committee on Capital Markets Regulation and price transparency analyses that may be undertaken assuming the National Association of Securities Dealers (NASD) releases Trade Reporting and Compliance Engine (TRACE) data as expected.

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With respect to **retail debt market** transparency, we recognize that price is an important factor in best execution and that direct retail involvement in government and corporate debt markets is expected to increase. For these reasons, we support and will contribute to consultations regarding educational and appropriate regulatory measures to promote what is required for retail investors investing directly in the debt market, including transparency in terms of content and access methods. We believe that the review of issues relating to transparency for retail investors should be undertaken by the IDA in the context not only of best execution, but also of retail issues more broadly, to identify whether it is transparency or other concerns that impede retail participation in bond markets.

BACKGROUND ON AND RATIONALE FOR RECOMMENDATIONS

Our recommendations are provided in the context of what we understand the CSA's transparency-related needs to be: namely, ensuring investor access to relevant pricing information and establishing a means for regulatory monitoring and surveillance to assure regulators that investors receive proportionately equitable and efficient treatment.

To provide the background for our recommendations, a distinction must be made between the centralized, commission-based, exchange/agency structure of the equities market and the generally decentralized, principal-based bid-offer-spread-driven structure of the bond market. Also, dealers in debt usually provide liquidity to their customers and, unlike in the case of equities, are hence at risk in their own portfolios. These differences have arisen and are perpetuated for historic and other reasons. For example, a review of annual reports shows that a firm may issue only one or a few equity instruments that are liquid as they trade regularly on an exchange, meaning up-to-date prices can be published without disclosing confidential information. The same firm may have multiple classes of bonds, causing the bond market to be far more fragmented and the bonds less liquid, making the posting of continuous prices difficult. Certain bonds may not trade for weeks or longer[1] and the price can therefore not be known with accuracy. The quantity of such bonds trading in the secondary market will have a significant effect on the market price for the proposed trade. The elastic correlation of size and price is critical to the bond trading process and should not be undermined by an arbitrary transparency standard. This is consistent with volume and value data: equity markets are characterized by many trades that are smaller in dollar value on average than debt trades; the debt markets have a low frequency of, on average, high-dollar-value transactions.

We believe that the transparency solution of equity markets should not be applied to debt markets without considering potential negative effects on, first, institutional investors that often rely on the anonymity that can be provided by brokers, IDBs and ATSs when these investors are in the market and, second, investors' ability to access liquidity – sell their bonds – if market-makers no longer believe that they can earn the returns necessary to cover their risk-adjusted costs of buying and holding bonds in inventory.

Given this market structure differentiation and the industry belief that regulation has a place only where the benefits exceed regulatory costs, IIAC investigated what has happened in the market since the 2003 regulatory approach to debt market transparency was implemented, the basis of the need for change at this time, the impacts of less flexible transparency requirements and other issues to consider as the Canadian approach to transparency is reviewed in the institutional and in retail markets.

(i) Market Forces Continue to Drive Progress

Since the original government debt transparency exemption was put in place in 2003, there have been significant advances in debt market transparency delivered by the marketplace in response to investor interest and competition. These include:

[1] TBMA data suggests that based on TRACE data, only 46 per cent of bonds covered trade at least once a month, "TBMA U.S. Response to European Commission Call for Evidence on Price Transparency in Non-Equity Markets," The Bond Market Association, September 18, p. 4

- CanPX Inc., which delivers comprehensive transparency with respect to federal and provincial government debt through *voluntary* agreement between IDBs and dealers despite the transparency exemption for government debt securities, has tripled its corporate coverage between 2003 and 2006 – there are currently approaching 200 legal entities receiving CanPX data, which is then further disseminated to other parties
- Large information vendors (e.g., Reuters, Thomson and Bloomberg) display increasingly broad price information on traded bonds and money market instruments to customers, including retail brokers
- Gmarkets Inc. packages financial information, including CanPX pricing data, for smaller institutional investors and Gmarkets has just introduced further price discounts for smaller firms
- Several dealers post closing prices on their websites
- Other information providers such as Thomson and Bloomberg make available interdealer and intraday prices
- Two ATSs, still in their early stages when the CSA exemption was announced in 2003, now provide extensive transparency and further ATSs are expected – trading volume on multidealer platforms can be expected to increase:
    - CanDeal provides comprehensive real-time pre-trade transparency (best bid/ask price, best bid/ask yield, best bid/ask quantity, number of dealers at the best bid/ask price, best bid/ask tick, best bid/ask time) for over 250 bonds, including all Government of Canada bonds and T-bills, a range of provincial and agency bonds, and CanPX corporate bonds
    - Perimeter CBID provides live, transparent, anonymous and executable trading (also for retail-sized transactions) in fixed-income securities for registered dealers and institutional investors (including governments and pension funds), as well as price access to retail clients and investment advisors
- Retail investors looking for low-cost transparency sources can access information via discount brokerages and increasingly through new internet-based services such as StockWatch (http://www.stockwatch.com/swnet/utilit/utilit_prices.aspx?pro=N&currency=U;*)*; as well, they can access free closing rates for benchmark securities on the TSX (http://www.tsx.com/HttpController?GetPage=BondsRates&Language=en) and Perimeter CBID (http://www.pfin.ca/product_cbid.asp) websites – these benchmarks provide a general indicator of the level and directional movement of the overall market and serve to provide relative values for other fixed income securities
- Perimeter CBID provides closing prices for a range of provincial and corporate bonds, as well as daily bond quotes, to the *Globe and Mail*'s *Report on Business* and RBC Global Services and Thomson Financial provide similar information to the *Financial Post*; prices are also available in *Les Affaires* and *La Presse*
- There has been further expansion of publicly available bond indices.

Moreover, there is evidence of continuing innovation in trading technologies, which will generate further improvements through healthy competition. For example, CanPX Inc. is investigating the feasibility of making end-of-day benchmark Canada bond prices available free of charge on its website. These prices could be accompanied by representative retail spreads by bond type to provide investors with rough measures of government and corporate bond prices: retail spreads can be expected to have a cost structure that exceeds that of institutional ones due to the smaller size of the typical trade.

As a result of the above voluntary market improvements, ***Canadian debt markets arguably provide a healthy level of transparency that compares favourably to that of other***

industrialized countries with the exception of the United States. The U.S. market has a larger amount of pre- and post-trade transparency in the fixed-income market than Canada as a result of the TRACE and GovPX systems. Of note, despite fixed-income transparency being mandated to a lesser extent in Canada, debt spreads in this country have declined as indeed did execution costs in the U.S. in non-TRACE-eligible bonds. Further discussion regarding the U.S. market and transparency is included in Section (iii).

(ii) Current and Future Institutional Problems Not in Evidence; Scope of Retail Problems Not Assessed

IIAC believes that there is a place for regulation, only where the benefits from such regulation would exceed the related costs. A key principle before introducing or strengthening regulation is that there be a defined problem, that it is measured to the extent possible, that benefits are quantified and that benefits exceed costs.

A 2002 survey jointly conducted by the Ontario Securities Commission and Investment Dealers Association of Canada indicated that there were no systemic and few individual problems identified in the institutional market, and that the market was in general self-policing. The CSA's National Instrument solicits views on the pros and cons of greater mandated transparency but does not identify further problems or quantify further benefits or associated costs. Section (i) notes improvements without regulation in that segment of the debt market and The Bond Market Association, including its Asset Managers Division, concludes that: "By subscribing to pricing services, trading with dealers through their proprietary trading systems and/or joining multi-dealer trading member systems, institutional customers can access substantially the same pricing information as primary dealers."[2]

That same OSC/IDA study said that there were perceived problems in the retail market, which the IDA was to examine. We believe that retail investors will increasingly be interested in considering debt as part of their portfolio and transparency in the retail debt segment should be examined by the IDA. As discussed in more detail in Section (iv), the IDA should (1) take into consideration the information required by, and its availability to, investment advisers (IAs) (who have an obligation to provide full disclosure, including compensation) and investors and (2) consider what combination of education and/or regulation (rules or guidelines) would best address any problems. We look forward to receiving analysis that may be underway by the IDA and/or that the CSA may commission and to participating in consultations.

(iii) Balanced Transparency Is Good; Excessive Transparency Will Increase Market Risk

The reluctance to mandate too much transparency reflects an overriding concern about damaging the liquidity of the markets. Unlike in exchange-traded markets, the liquidity of principal-based over-the-counter (OTC) fixed income markets rests in large part on the ability and willingness of dealers to hold inventory and make markets. The impact of mandated pre- and post-trade transparency on the liquidity of corporate and government markets ultimately is, it has been said, a question of how far regulation, if needed, should go and how fast. Increased risk will result in increased prices.

A Centre for Economic Policy Research study commissioned by the City of London reviewed existing analyses on transparency, liquidity and efficiency, concluding that in some of these analyses' "theoretical propositions are conflicting, and some of the evidence in the empirical work is contradictory." It uses empirical and theoretic approaches to further study transparency, liquidity and efficiency issues. From the former, it concludes in part that: "Greater transparency is associated with lower trade size and possibly higher spreads. Some degree of opacity seems

[2] "TBMA U.S. Response to European Commission Call for Evidence on Price Transparency in Non-Equity Markets," The Bond Market Association, September 18, 2006, p. 2

necessary to induce dealers to supply both liquidity and pre-trade information." From the latter, it concludes that the introduction of full transparency in the context of European government bonds "can drain liquidity from the government bond market abruptly and completely."[3] With respect to the government debt market, it should be noted that apparently no other industrialized country mandates government debt market transparency except the U.K. to a limited extent that has been far surpassed by that marketplace voluntarily.

While the U.S. Securities and Exchange Commission (SEC) has concluded that there is a relationship between increased transparency and lower transaction costs, institutional investors in the U.S. questioned whether this conclusion holds in all circumstances. In a June 6, 2005 article entitled "High-Yield Players Hit by Downside of TRACE," *BondWeek* noted:

> *"High-yield market participants say transparency in the credit markets is rearing its head, with the National Association of Securities Dealers' Trade Reporting and Compliance Engine (TRACE)* ***hampering the ability to trade large blocks of bonds in a declining market****. Additionally, they argue TRACE, which began offering transaction and price data on the entire universe of corporate bonds in February, has increased market volatility overall as even relatively small trades can quickly cause the market to reprice."*

While this quote is directed at low-grade debt, The Bond Market Association (TBMA) and its Asset Managers Division, in a recent submission to the European Commission on transparency, noted that U.S. broker/dealers believe that:

1. liquidity measured by volume has decreased by close to a third since TRACE was enacted based on MarketAxess data
2. broker/dealers are doing more proprietary trading
3. broker/dealers are less willing than previously to put capital at risk as spreads may not compensate them.

The TBMA report critiques previous statistical studies in depth, noting, for example, that they measure liquidity by bid-ask spreads rather than volume, that academics did not have access to complete data and that available data shows that trade volumes declined during TRACE implementation. It also notes that the increase in transparency through TRACE has taken place in a "benign credit environment," meaning that these studies' findings – even ignoring what the TBMA sees as methodological flaws and questionable conclusions in some cases – may be suspect, especially in periods of extreme volatility when dealers may not want to take the risk of sudden and significant price shifts.[4] As well, the TBMA points out that four market-driven initiatives towards full transparency have not survived, although does not suggest that the level of transparency was the only reason for this.[5]

The questions regarding transparency in the U.S. marketplace, which is the deepest most liquid market in the world, lead to grave concerns about possible repercussions in our market. While additional transparency may work to narrow spreads, it could also widen them. Absolutely and proportionally compared to the U.S. market, the Canadian fixed income market: is significantly smaller in size, is in an earlier stage of development based on turnover, has a higher issuer concentration and displays greater industry concentration (60 per cent in financial services that have a 90 per cent correlation in returns). ***While Canada may represent 10 per cent of the U.S. population, the Canadian bond market represents only an estimated 1.7 per cent of***

[3] "European Government Bond Markets: transparency, liquidity and efficiency," CEPR Research Report Published by the Corporation of London, May 24, 2006, pp. 5 and 6

[4] "TBMA U.S. Response to European Commission Call for Evidence on Price Transparency in Non-Equity Markets," The Bond Market Association, September 18, 2006, p. 2

[5] "TBMA U.S. Response to European Commission Call for Evidence on Price Transparency in Non-Equity Markets," The Bond Market Association, September 18, 2006, p. 2

global fixed income markets based on Bank for International Settlements data on debt outstanding as at March 2006.

Due to this disparity in market size, we urge caution if considering capital markets solutions from south of the border in Canada without careful analysis and consideration by key stakeholders. These include institutional investors and major issuers such as the federal and provincial governments. As Canadian federal, provincial and municipal government debt trading represents 95 per cent of total Canadian fixed income trading,[6] we will be particularly interested in these government issuers' response to the National Instrument. ***Can Canada risk – rather than a market-driven evolutionary change – an experiment to find out the effects of more transparency, knowing that if there were to be a negative effect, it would take some time for the market to re-adjust to any later corrections in policy directions?***

It is noteworthy that the U.K. Financial Services Authority declined to mandate any advances in transparency beyond existing levels, instead relying on the marketplace to deliver incremental transparency, despite its claim to being the second most liquid market in the world after the U.S. Responding in July 2006 to comments on transparency received in late 2005, the FSA concluded:[7]

- There is no evidence in the U.K. of widespread market failure due to transparency that warrants regulation – competition, market-driven transparency, interaction between the cash and credit derivatives markets and regulation are sufficient to deliver efficient pricing and fair executions.
- There are very few direct U.K. retail participants in the secondary bond markets and concerns about retail participation in bond markets relate mainly to non-transparency matters.
- Whether differences in the availability of trading information to different types of institution is a market failure, or reflects that in any market some have better access to information, is unclear – the FSA expects the market to generate appropriate solutions for such problems.
- Regulators must exercise extreme caution in mandating greater transparency in the U.K. or Europe because:
    - Greater pre-trade transparency will likely have an impact in unknown, but potentially significant ways, at a time when these markets continue to evolve
    - While changes to post-trade transparency may have less impact on market structure, further analysis of the trade-off between transparency levels and the provision of liquidity, especially for less liquid bonds, is required
    - The reduced transaction costs that the U.S. transparency system TRACE is credited with bringing about in the U.S. is unlikely to be repeated to the same extent in the U.K. because of differences in market structures.

Just as we have concerns if we were to apply U.S. solutions in Canada due to differences between the marketplaces, we reiterate our concerns about applying equity markets solutions to debt markets. As noted above, the significant difference between the two market structures mean that the transparency solution of equity markets cannot be applied to debt markets without negative effects on institutional investors that may demand anonymity when they are in the market and on their ability to sell their bonds if market-makers no longer believe that they can earn the returns to cover their risk-adjusted costs of buying and holding debt in their portfolios.

[6] Source: Market Trade Reporting System (MTRS)

[7] "Trading Transparency in the UK Secondary Bond Markets: Feedback on DP05/5," U.K. Financial Services Authority, July 2006

(iv) Defer Changes to Take Advantage of Transparency Analyses Elsewhere; Address Concerns in Retail Market

The FSA is monitoring work on transparency by two European governing authorities (scheduled to complete work by the end of 2007) and may decide on further action at a later date. The two organizations are: the European Commission, which is considering trading transparency in the secondary bond markets in 2007, and the European Union (EU), which, as part of the Markets in Financial Instruments Directive (MiFID), is expected to introduce a pan-EU transparency regime, starting with shares and possibly later extending to other asset classes. The results of these reviews will be particularly interesting as EU debt markets have converged in size with the U.S. markets on the basis of debt outstanding to GDP[8]. The U.S. has just established a Committee on Capital Markets Regulation to look at issues negatively impacting the competitiveness of U.S. markets, and this committee may include transparency in their review. Also, NASD has asked for comments on disseminating historical TRACE data, including trading volume, which is considered the standard measure of liquidity – to date, this data has not been available to all parties for analysis and, when released, it will be valuable in more comprehensively analysing price transparency based on volume.

On the institutional side, Canada can afford to wait for the results of these reviews. With respect to the retail market – and this is defined simply to be where a retail client buys debt directly, rather than holds debt through a company pension plan or other vehicle where the pricing and transparency is at the institutional level – there are a number of issues to consider. ***The Client Relationship Model (formerly the Fair Dealing) Model is based on the premise that retail investors should understand what they are paying and what they are getting.*** Price ttransparency for retail investors is certainly an important issue in this exercise, although a lack of transparency may well have a considerably smaller effect on absolute net retail returns than will a poor understanding of other features of the debt market, such as bond covenants, small issue size, tax treatment and unique structures. These latter issues may expose investors to liquidity and credit risks significantly beyond those in the equities market or associated with access to less than full pricing disclosure, especially as many retail investors tend to buy and hold bonds. For this reason, the content of and access to transparency may be a lower priority. For example, TRACE's free investor website, in operation for some years, receives only 55,000 hits a month, according to a recent SEC speech, including hits by media, students, academics, institutional investors and foreign investors in addition to retail investors. A comparable system in Canada, a country whose domestic debt securities outstanding equate to only 3.7 per cent of those of the U.S., could therefore translate into just 2000 hits a month or approximately 100 per day. This is considerably less than, for example the 9,000 individual visitors *a day* to www.sedar.com. Also, TBMA's review of its investing in bonds website determined that what the viewers use most frequently is not transparency data but ratings, tax implications, economic indicator information and commentaries on different markets.

When considering retail price transparency, regulators should also consider that high-net-worth retail investors will be able to access some of the pricing options of institutional investors and that other retail investors buy fixed income products through brokers or funds that have access to institutional pricing.

As noted above, the IDA should take into consideration the required information, its availability to IAs (who have an obligation to provide full disclosure, including regarding compensation) and investors, and what combination of guidelines, rules and education would best address any

[8] "Response to FSA Discussion Paper 05/05 on Trading Price Transparency in the U.K. Secondary Market," The Bond Market Association, European High Yield Association, EMTA, European Primary Dealers Association, European Securities Forum, December 5, 2005

problems. We look forward to receiving analysis that is underway by the IDA and/or that the CSA may commission, as well as to participating in related consultations.

ANSWERS TO CSA QUESTIONS

- **Transparency for Government Debt Securities**

  CSA Recommendation: "…marketplaces and IDBs would be required to report order and trade information for designated benchmark government debt securities to an information processor (or, in the absence of an information processor, to an information vendor that meets the applicable standards). Order information would be reported in real time and trade information within one hour from the time of the trade. The information displayed would be subject to volume caps of $10 million for fixed income securities issued or guaranteed by the government of Canada, and $2 million for all other government debt securities."

  Question #1: Should there be a mandatory requirement to report and disseminate information related to designated government debt securities? What are the benefits and disadvantages of this and the alternative approaches?
  Question #2: Should dealers be subject to order and/or trade transparency requirements for government fixed income securities? If so, should they be required to report order information, trade data or both?
  Question #3: What type of pre-trade information should be disseminated? Should it include indications of interest?
  Question #4: Are the reporting timelines appropriate – i.e., order information in real time and trade information within one hour of the time of the trade?
  Question #5: Are the volume caps applicable to government fixed income securities set out in the Companion Policy to NI 21-101 adequate? Should there be further tiering of volume caps for the different types of government bond securities?

  IIAC Response: As previously noted, we are concerned that the above implies applying equity-markets solutions to debt markets – even the word "orders" is a convention of the equities market but not of debt markets where bids and offers prevail. What determines best execution also varies between the different markets. As noted above, the significant difference between the two market structures mean that the transparency solution of equity markets cannot be applied to debt markets without having negative effects on institutional investors that first, often rely on the confidentiality that can be provided by brokers, IDBs and ATSs when these investors are in the market and, second, puts investors' ability to access liquidity at risk if market-makers no longer believe that they can earn the returns to cover their risk-adjusted costs.

  As previously noted, we believe that transparency in the institutional market has expanded effectively for governments and corporate bonds through market forces rather than regulation. At the same time, we have not seen evidence from the CSA or the market that suggests that the costs to implement and administer greater regulated transparency will result in greater benefits for investors. Additionally, the effect of increased transparency on spreads is uncertain; in fact, it could reduce market participant willingness to provide liquidity, which would potentially widen spreads. This may only be identified after the fact and could prove to be a trend difficult to reverse. Finally, existing information sources provide a range of information and market forces are leading firms to offer service packages meeting the needs of different investors. Additional reporting requirements should only be based on CSA quantification of expected net benefits presented in comparison to expected costs. As part of such an exercise, we suggest that the CSA also take into account the results of transparency analyses underway in the United Kingdom, Europe and possibly the U.S. before coming to a decision.

There are a number of firms that do not report transparency information to the Information Processor. Some are small and requiring them to report would add cost to these smaller players without an indication of significant benefit – we recommend that firms required to report for corporate debt transparency purposes remain those firms that have market share of at least a half of one per cent of total corporate bond trading.

With respect to volume caps, we note that a tiering of caps many not address the issue that the CSA may be seeking to address, namely pricing for less-frequently-traded securities.

- **Transparency for Corporate Debt Securities**

***CSA Recommendation:* "**The current transparency requirements for corporate fixed income securities set out in NI 21-101 are different than those applicable to government debt securities. Specifically, while IDBs and ATSs are required to provide both order and trade information for government debt securities to an information processor,{13} NI 21-101 only requires marketplaces to report order information for corporate bond securities to the information processor and marketplaces, IDBs and dealers to report corporate bond trade information. We will maintain the requirements with respect to the corporate debt securities. Specifically, marketplaces, IDBs and dealers would continue to be required to provide post-trade information regarding designated corporate debt securities to an information processor, subject to volume caps (within one hour of the trade).

Question #6: Should we require pre-trade transparency for corporate fixed income securities? If so, should the requirements be applicable to marketplaces only or should they also apply to dealers?
Question #7: Should the time for reporting the trades be reduced (for example, should all trades be reported and disseminated in real time)?

IIAC Response: As previously noted, we are concerned if the above means applying equity markets solutions to debt markets. As noted above, the significant difference between the two market structures means that the transparency solution of equity markets cannot be applied to debt markets without having negative effects on, first, institutional investors that often rely on the confidentiality that can be provided by brokers, IDBs and ATSs when the investors are in the market and, second, investors' ability to access liquidity if market-makers no longer believe that they can earn the returns to cover their risk-adjusted costs.

We believe that transparency in the institutional market has expanded effectively for governments and corporate bonds through market forces rather than regulation. At the same time, we have not seen evidence from the CSA or the market that suggests that the costs to implement and administer greater regulated transparency will result in greater benefits for investors. Additionally, what benefits there may be from narrowed spreads could be offset by reduced willingness to provide liquidity, which would potentially widen spreads. This may only be identified after the fact and could prove to be a trend difficult to reverse. Finally, existing information sources provide a range of information and market forces are leading to service packages meeting the needs of different investors. Additional reporting requirements should only be based on CSA quantification of expected net benefits presented in comparison to expected costs. As part of such an exercise, we suggest that the CSA also take into account the results of transparency analyses underway in the United Kingdom, Europe and possibly the U.S. before coming to a decision.

There are a number of firms that do not report transparency information to the Information Processor. Some are small and requiring them to report would add cost to these smaller players without an indication of significant benefit. ATSs could be required to report to the Information Processor for more complete and convenient information.

With respect to volume caps, we note that a tiering of caps will not really address the issue that the CSA may be seeking to address, namely pricing for less-frequently-traded securities.

- **Designated Fixed Income Securities**

CSA Recommendation: "The Canadian securities regulatory authorities expect that, for government fixed income securities, the information processor would also designate securities representative of the government fixed income market. For example, in order to help ensure that a level of transparency that is useful to investors is achieved, the most liquid government bond securities would qualify as designated securities."

Question #8: Has the process for designating benchmark corporate fixed income securities been effective? Please explain your response.

IIAC Response: The methodology for the selection of benchmark corporate fixed income securities on CanPX is publicly available on the CanPX website (http://www.canpx.ca/selectioncriteria.jsp) and the selection process generates healthy discussion amongst industry participants. Over three years, it has lead to a tripling in corporate benchmark bonds. As well, as ATSs expand, additional information will be provided.

We believe that CanPX provides greater flexibility than would regulation and that it preserves its independence from the marketplaces, inter-dealer bond brokers and dealers that provide data through:

1. Broad share ownership – provision is also made for others to become shareholders
2. Secretariat services provided by an unrelated third party, the IIAC
3. Declaration by Directors of any known conflicts of interest in any agenda topic at the beginning of every meeting and again if any unforeseen issue arises during a meeting
4. Periodic guest participation of Bank of Canada representative as another key stakeholder in Canada's debt markets
5. Periodic review by the OSC of all aspects of the operations of CanPX, including access to minutes and all documentation
6. Minutes circulated to all shareholders.
7. It should be noted that Board members and shareholders do not acquire data directly from CanPX but from CanPX vendors at the same prices, time and terms as other parties

Benchmark data provide a good general indicator of the level and directional movement of the overall market and offer relative values for other fixed income securities. They are publicly available via Perimeter CBID and, to a lesser extent, the TSX and daily bond quotes are provided to the *Globe and Mail*'s *Report on Business* and *Financial Post*. CanPX Inc., as well, is investigating the feasibility of making end-of-day benchmark Canada bond prices available free of charge on its website, possibly accompanied by representative retail spreads by bond type to provide investors with rough measures of government and corporate bond prices.

Question #9: Has there been sufficient progress, both regulatory and industry-driven, regarding fixed income transparency to date? For retail investors? For large and small institutional investors?

IIAC Response: As noted, a 2002 survey by the OSC and IDA indicated no systemic and, in fact, no real concerns on the institutional side – institutional investors continue to strengthen in market power and the 2002 study noted that the market was self-policing. This strongly argues for no changes on the regulatory front, especially given the advances in transparency since then described in Section (i), despite the exemption and limited corporate transparency mandating and the continuation of reliance on market forces. With respect to the retail marketplace, we believe that there is room for further discussion as noted above. Analysis and consideration of solutions should be fact-based, and we look to work with the IDA on this project.

- **Electronic Audit Trail Requirements**

CSA Comment: The TREATS project includes, among other things, establishing technology requirements for interfaces between the facility and dealers and implementing recording and business processes to enable dealers to respond to regulators' requests, identified as the responsibility of dealers and marketplaces. The regulators have been meeting with dealers, marketplaces and service providers to document and confirm data modeling, including the information that must be electronically recorded and available. Once this work is completed by the fall, the regulators intend to complete a cost-benefit analysis before deciding whether to proceed.

IIAC Response: We are pleased that a cost/benefit analysis of TREATS will be undertaken and look forward to the results of the research.

We believe that the IDA has the tools to assess the depth of retail issues and that this should be undertaken before changes in transparency requirements are contemplated. As said, a lack of transparency may well have a considerably smaller effect on absolute net retail returns than will a poor understanding of other features of the debt market, such as bond covenants, small issue size, tax treatment and unique structures.

We support and will contribute to consultations regarding educational and, where warranted, appropriate regulatory measures (guidelines or rules) to promote what is required for retail investors investing directly in the debt market, including transparency in terms of content and access methods.

- **Clarification of Best Execution and Other Obligations in a Multiple Marketplace Environment**

CSA Comment: The CSA continues to believe "… that availability of pre-trade and post-trade information is essential to facilitate best execution and market integrity, especially with multiple marketplaces trading the same securities. Under current requirements, dealers should be taking into consideration information from all marketplaces trading the same securities and taking steps to access orders. This is consistent with the views expressed in the industry committee report that "pre-and post-trade data consolidation is necessary in Canada amongst marketplaces offering execution on the same securities". Although [the CSA's] review of trade-through and best execution generally is ongoing, [the CSA believes] believe that it is important to clarify … expectations on this particular issue [through amending] the Companion Policy to NI 23-101 by adding the following section:

> *"In order to meet best execution obligations, we expect that a dealer will take into account order information from all marketplaces where a particular security is traded (not just marketplaces where a dealer is a participant) and take steps to access orders, as appropriate. This may include making arrangements with another dealer who is a participant of a particular marketplace or routing an order to a particular marketplace, where appropriate."*

IIAC Response: In this submission, we are limiting our comments to debt market transparency. In this context, we are not aware of evidence of problems in the institutional bond market that are not quickly self-correcting. We agree that best execution as regards retail investors warrants review and look forward to participating in related IDA consultations. Commissions and self-regulatory organizations must consider this issue from two perspectives – one from what constitutes best execution – which considers issues well beyond price – and second in terms of the appropriate response to any findings: whether the solution should be education, hard rules or guidelines. We believe that education about the information sources available is critical and are reviewing what the IIAC can do to make information on sources better available. We think that any regulatory involvement should be principles-based as best execution is very much a function of client preferences, the market and other matters and therefore cannot be defined effectively in a rule.

IIAC suggests the term "best execution" be reviewed in the context of the bond market. The wording "orders" in the CSA's comment above is the term generally used to define an action where a market participant has a fiduciary duty from its agency position in respect to a client "order". The bond market does not have an equivalent situation of "orders," as investors trade with dealers as principals. We refer you to the definition of "best execution" proposed by the Association for Investment Management and Research (AIMR) (now the "CFA Institute"), which is broad and linked to long-term trading results. The definition also provides evidence that the concept of best execution varies from market to market. The CFA Institute says "determining the quality of trade executions entails the evaluation of subjective, objective and complex qualitative and quantitative factors."[9] It goes on to say that best execution is a prospective, statistical and qualitative concept that cannot be known with certainty ex ante. It is interwoven into complicated, repetitive and continuing practices and relationships.

We caution the CSA and SROs to avoid the dangers of creating trading rules that interpret "best execution" too narrowly.

- **Requirements for and Status of Information Processors for Debt and Equity**

  ***CSA Recommendation – Equity:* "**Currently, there is no information processor for equity securities. However, [the CSA continues] to believe that consolidation of data is important to address best execution and market integrity issues, especially in a multiple marketplace environment … at this time, [the CSA believes] that an information processor would ensure that a central source of consolidated data that is consistent and meets the standards approved by the regulators exists and encourage any interested parties to apply as an information processor for the purpose of consolidating pre-trade and post-trade information for the equity markets."

IIAC response: In this submission, we have limited our comments to debt market transparency. However, the IIAC has significant concerns in respect of the proposed amendment to Companion Policy to NI 23-101 regarding best execution in a multiple marketplace environment. Although this amendment is characterized in the Notice as a clarification, it has significant and far reaching effects on firm processes, costs and ability to achieve best execution. The significance of the proposed clarification is partially illustrated in the RS Market Integrity Notice – *Request for Comments relating to Provisions Respecting Competitive Marketplaces*. The Market Integrity Notice outlines a number of changes in practice that firms will have to implement in order to comply with the requirements. These process requirements entail costly changes to systems and process requirements. Certain of the requirements may have the effect of working against best execution. In addition, there are concerns about the ability to monitor and enforce the requirements.

The details relating to the specific problems of the proposed amendments will be provided in the IIAC's response to the Market Integrity Notice, which we will also direct to the CSA. Until such time as RS receives and analyzes these comments, we believe it would be pre-mature to enact the proposed amendments to Companion Policy NI 23-101.

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[9] *Trade Management Guidelines*, Association for Investment Management and Research (AIMR) now the CFA Institute), 2002, p. 2.

CSA Recommendation – Debt: ***"***The 2003 ATS Rules retained transparency and data consolidation requirements for corporate debt securities, for which CanPX had recently been approved as the information processor. Government debt securities, however, were exempted from the transparency (and, therefore, data consolidation) requirements until December 31, 2006. [The CSA notes] that CanPX's approval as the information processor for the debt markets expires on December 31, 2006. To the extent that transparency of more debt securities, including government debt securities, is phased in, the importance of having a robust system increases. While [the CSA] will be considering extending CanPX's approval, [the CSA published with its] Notice a separate notice to invite other entities that are positioned for the role to apply.

IIAC response: We believe that the institutional and retail transparency regime should include the overall marketplace. This includes brokers, IDBs and ATSs and we recommend that firms required to report for corporate debt transparency purposes should remain those firms that have market share of at least a half of one per cent of trade volumes.