INVESTMENT DEALERS ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DES COURTIERS EN VALEURS MOBILIÈRES

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PRESIDENT AND CHIEF EXECUTIVE OFFICER

October 12, 2006

Alberta Securities Commission
British Columbia Securities Commission
Manitoba Securities Commission
New Brunswick Securities Commission
Securities Commission of Newfoundland and Labrador
Registrar of Securities, Department of Justice, Government of the Northwest Territories
Nova Scotia Securities Commission
Registrar of Securities, Legal Registries Division, Department of Justice,
Government of Nunavut
Ontario Securities Commission
Prince Edward Island Securities Office
Saskatchewan Financial Services Commission
Registrar of Securities, Government of Yukon

c/o John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
Suite 1900, Box 55
Toronto, Ontario M5H 3S8

And

Madame Anne-Marie Beaudoin
Directrice du secrétariat
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, tour de la Bourse
Montréal, Québec H4Z 1G3

Re: IDA Response to CSA Request for Comments on Notice of Proposed Amendments to National Instrument 21-101 Marketplace Operation and Companion Policy 21-101CP and National Instrument 23-101 Trading Rules and Companion Policy 23-101CP

I am pleased to provide, on behalf of the Investment Dealers Association of Canada (IDA), our comments regarding the Canadian Securities Administrators' (CSA) Notice of Proposed

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Amendments to National Instrument 21-101 Marketplace Operation and Companion Policy 21-101CP and to National Instrument 23-101 Trading Rules and Companion Policy 23-101CP (together, the ATS Rules).

The IDA is the national self-regulatory organization of the securities industry. Our members include more than 200 investment dealers who play an essential role in the Canadian economy. In addition, five inter-dealer brokers (IDBs) who act as intermediaries between dealers to facilitate inter-dealer trades are currently approved by the IDA. Our mandate is to protect investors and enhance the efficiency and competitiveness of the Canadian capital markets.

Data Transparency in the Fixed Income Market

The IDA is in principle supportive of the efforts being made to ensure data transparency, including pre-trade and trade transparency, with respect to trades made through dealers, on marketplaces and through IDBs. In particular, the IDA believes that further transparency may be warranted in the context of the retail over-the-counter debt markets.

However, the IDA is of the view that currently there is not sufficient supporting evidence to warrant regulatory intervention that mandates pre-trade and trade transparency for government fixed income securities or that changes the current regime for corporate fixed income securities. Notably, the IDA has not received any complaints from investors, either retail or institutional, regarding the current level and availability of bond pricing information.

In addition, even in the absence of further regulatory intervention, market forces have caused data transparency to increase and it appears that this industry-driven trend towards increased transparency will continue.

Although it may be demonstrated that some form of increased debt market transparency would be beneficial to at least some market participants, any initiatives to increase transparency must provide useful and accessible information to the market participants who require increased transparency, while still avoiding adverse consequences such as decreasing the debt market's liquidity. There is currently no evidence that the proposed amendments to the ATS Rules will achieve these desired results. It would therefore be premature to implement the proposed amendments, or any other changes to the ATS Rules, without evidence of market failure.

Further research and consultation, addressing issues such as the size and nature of the retail fixed income market, the retail fixed income market's current access to trade information and the data requirements of that market, must be conducted before any amendments are made to the current ATS Rules.

The IDA has already begun this process through the debt market survey which it is currently conducting and which is described further below. This survey will ascertain foundational information such as the size of retail participation in the Canadian debt markets, the nature of products being purchased by retail investors, and retail bond pricing practices. The resulting information will assist in determining the transparency needs of the retail debt market. It will also provide the groundwork for further studies the IDA is committed to undertake, concerning issues such as the current level of retail debt market transparency and the requirements of the retail debt market investor.[1]

Institutional versus Retail Debt Markets[2]

There are significant differences between the structure and operation of the Canadian retail and institutional fixed income markets. For example, although the precise numbers are not known at this time, the percentage of fixed income trades attributable to retail investors is large but highly disproportionate to the dollar volume of those trades, which is dwarfed by the dollar volume of trades conducted by the institutional side of the fixed income market.

Retail investors generally have different investment strategies than institutional investors vis-à-vis fixed income securities. A retail investor tends to employ a "buy and hold" investment strategy and is much more likely to hold a bond to maturity for the purpose of receiving the steady income stream provided by the bond's coupon payments. Additionally, whereas an institutional investor can survey the street, including dealers and even ATSs, for the best price for a particular security and choose the dealer from which to buy that security, a retail investor holding an account at a major brokerage is generally limited to the debt inventory held by his or her dealer.

Furthermore, the current level of pre-trade and trade price transparency is not easily accessed by retail investors. Institutional investors have access to but pay for this price transparency information. Appendix A to this letter provides a list of currently available sources of bond price information.

Any attempts to increase transparency in the Canadian debt markets must be mindful of the differing structures and needs of these two markets.

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1 In addition to "made-in-Canada" research and consultation, research respecting foreign bond markets will likely also provide useful information. For example, the European Commission is performing a review to determine whether the share market transparency requirements set out in the Markets in Financial Instruments Directive (MiFID) should be extended to additional asset classes such as bonds. The Commission is due to present its report in October of 2007. The UK's Financial Services Authority (FSA) issued its Discussion Paper 05/5, "Trading Transparency in the UK Secondary Bond Markets" (September 2005), and its subsequent Feedback Statement 06/4 "Trading Transparency in the UK Secondary Bond Markets" (July 2006), to assist in preparing its input for the Commission's review. (FSA Feedback Statement 06/4, p. 3.)

2 The majority of the comments in this response are directed towards the proposed amendments to the government debt transparency requirements, as these are the rules which are being amended under the proposed rule changes. However, these comments are equally applicable to over-the-counter corporate debt markets and transparency in those markets.

Institutional Debt Market

Participants in the institutional fixed income market believe that the current level and nature of price transparency, both for government and corporate fixed income instruments, is sufficient and adequate and that market-driven initiatives to increase transparency have been sufficient and successful. The IDA is also of the view that there is sufficient transparency with respect to the institutional fixed income market. It therefore can be concluded, at least from an institutional market perspective, that there is no need to mandate further disclosure at this point in time.

Retail Debt Market

Unlike in the institutional debt market, it is more evident that further data transparency may be required by the retail fixed income market.[3] If there are retail investors who want but are not getting the required price information (either directly or through their retail advisor), then there is a strong argument for increased transparency.[4] However, this case has not (yet) been made.

The particular transparency "problems" of the retail debt market must be identified before solutions can be created to solve those transparency problems. It cannot be assumed that the currently mandated (or proposed) transparency requirements, which may be of some use to dealers, marketplaces and institutional investors, would provide helpful or even comprehensible information to retail investors. For example, the common "buy and hold" strategy among retail fixed income investors will likely affect and inform the appropriate level of transparency required: given the tendency to buy and hold, it is possible a bond yield table would provide sufficient and appropriate disclosure for the retail market.

Before an initiative can be crafted to increase information transparency for participants in the retail debt market, further knowledge about various aspects of the retail debt market, such as the following, is necessary:

- Size of the market, both in absolute value and size and number of trades[5];

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3 However, it should be noted that the FSA has concluded that bond market transparency for retail investors is not a major issue. However, best execution is of concern to retail investors. The FSA is of the view that the best execution requirements that will be implemented through MiFID should address the key retail bond market concerns, because best execution requirements by their nature are "designed to protect those participants that are less well-placed to obtain transparency information and judge prices." (FSA Feedback Statement 06/4, *supra* note 1, at p. 6.)

4 However, as noted earlier, there have been no complaints from retail investors regarding the current level or nature of debt market transparency.

5 The FSA commented in FSA Feedback Statement 06/4, *supra* note 1 at p. 15, that there is a smaller proportion of direct retail participation in the bond market in the UK as compared to the US, where NASD's Trade Reporting and Compliance Engine (TRACE) was implemented in part to provide better transparency to retail debt market participants. Because of this differential in retail participation, the FSA concludes that the

- Nature of the retail market investor;
- Nature of fixed income products purchased by the retail investor;
- Retail debt instrument price spreads;
- Retail investors' method of purchase (i.e. primarily through retail advisor or through discount brokerage);
- Retail investors' access to order, price and yield information, including ease and cost of access and nature of information provided (i.e. through retail advisor, discount brokerage, newspaper, data services such as CanPX, information services such as Reuters or Bloomberg, etc.);
- Retail advisors' access to order, price and yield information, such as CanPX;
- How retail investors wish to access order, price and yield information;
- The type and level of information required by a retail investor so as to make a determination as to whether a product is priced fairly, and how this information should get into the investor's hands;
- Evaluation of the appropriateness of the information disclosure provided by current sources of information available to retail investors; and
- The necessity of mandating increased transparency given the current sources of information.

These questions should be answered before a determination can be made as to: 1) the appropriate level of pre-trade and trade transparency for retail fixed income investors; and 2) how this transparency can be achieved. The IDA is committed to obtaining the information necessary to appropriately address these issues.

Furthermore, the preceding issues must be addressed before it can be determined whether the current proposed amendments to the ATS Rules will foster increased transparency with respect to fixed income pricing for the retail market. It would therefore be premature for the government fixed income transparency requirements to come into effect at the beginning of 2007.

Any initiative to increase transparency for retail debt market investors, whether it be the proposed ATS Rule amendments or a future initiative directed at retail investors, should be cost-effective and provide information that is accessible and easy to understand for the average retail debt market investor as well as promote efficient capital markets and benefit the public.

The success of the CSA's transparency initiatives will also be dependent on and should be considered in conjunction with other related CSA projects and initiatives. In addition, the IDA is

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introduction of a TRACE-like system in the UK would have a different cost-benefit trade-off with respect to retail investor protection.

currently working on relevant rule change proposals that will provide retail debt market investors with more information, including rules to address retail bond mark-up (fair pricing) practices and the disclosure of bond yield on bond purchase confirmations.

IDA Debt Markets Survey

The IDA is currently in the process of conducting a debt market survey of 19 Member firms who are Bank of Canada primary dealers or government securities distributors. The survey focuses on best execution and pricing issues and encompasses both retail and institutional debt markets.

The survey will:

- assess Member adoption and implementation of:
    - IDA Policy 4 *Minimum Standards for Institutional Account Opening, Operation and Supervision*;
    - IDA Policy 5 *Code of Conduct for IDA Member Firms Trading in Wholesale Domestic Debt Markets*; and
    - IDA Policy 5B *Retail Debt Market Trading and Supervision*

  prior to the IDA's risk assessment of Member firms;
- assess how Member firms supervise debt market trading;
- gather information regarding Members' fixed income trading systems;
- obtain debt pricing and transactional data, including data with respect to retail bond mark-up practices;
- obtain information regarding retail participation in the fixed income market; and
- gather information regarding the structured products currently being offered.

Much of this information, particularly that which is directly relevant to retail fixed income investors, is a necessary precursor to any recommendations or determinations with respect to increasing transparency for the retail debt market. Although this survey is an important first step, it will not provide the complete picture required to assess the transparency requirements of the retail fixed income market. The IDA will use the information gathered from the debt market survey to provide the framework for further research it will be conducting into retail debt market transparency.

Costs versus Benefits of Mandatory Increased Transparency

It is possible that an increase in data transparency (in particular pre-trade price transparency and an increase in frequency of trade reporting), instead of increasing the efficiency of the fixed income market, could adversely affect it. We agree with the approach of the Financial Services Authority (FSA), the UK financial markets regulator: further analysis of the potential trade-offs between transparency levels and market liquidity should be conducted prior to the implementation of regulatory changes.[6]

The FSA has recently analyzed the issue of secondary bond market transparency and is mandating a cautious approach to any increases in bond market transparency in the UK and Europe.[7] In particular, the FSA has concluded that mandated pre-trade transparency is likely to impact the existing market structures "in potentially significant but unknown ways."[8] Furthermore, the FSA concluded that increases in post-trade transparency, although they may have less impact on market structure than pre-trade transparency, could possibly result in decreased liquidity.[9]

Additionally, increased transparency, such as shorter time frames for data reporting, may be operationally difficult and costly for dealers.

Given the lack of demonstrated need for transparency in the institutional debt market and the currently unknown needs of the retail debt market, the costs of increased mandatory disclosure do not appear sufficiently low to justify the equivocal benefits of the current proposed ATS Rule amendments. Any benefits gained through mandatory transparency would likely be outweighed by the costs. However, the conclusion that mandatory price transparency is not warranted may change in the event that the provision of voluntary data, such as the IDB feeds of government debt pricing information to CanPX, is removed from the market.

<u>Responses to Specific Request for Comment Questions</u>

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?

> As discussed above, the IDA does not feel that there should currently be mandatory reporting requirements for government debt securities. For the reasons discussed, including the current voluntary provision of bond pricing information by the IDBs, the IDA is of the view that mandated transparency for the fixed

6 FSA Feedback Statement 06/4, *supra* note 1, at p. 6.
7 *Ibid.* at p. 5.
8 *Ibid*.
9 *Ibid.* The FSA has concluded that the current literature is inconclusive about the relationship between transparency and market liquidity and efficiency. (*Ibid.* at 16.) Furthermore, the Bond Market Association is of the view that it is too early to draw any reliable conclusions regarding the effects that the reporting of TRACE data has had on transparency, and points to anecdotal evidence that liquidity has deteriorated in the high yield market. (The Bond Market Association, "Response to FSA Discussion Paper 05/5 on Trading Transparency in the UK Secondary Bond Market" (December 5, 2005) at pp. 23-24.)

income market should be deferred for a further five years, until December 31, 2011.

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?

In the event that trade price reporting for government debt securities becomes mandatory, the trade price reporting should be applied equally to dealers, marketplaces and IDBs. This is necessary to ensure equal treatment and a fair and efficient market. For example, if the mandatory requirements were not applied to dealers, there is a danger that investors or dealers will place trades with other dealers directly over the phone instead of through a marketplace or an IDB to avoid the reporting of those trades. Any transparency of pricing data should be applied equally and across the board.

If government debt market transparency becomes mandatory, it should apply only to firm, unconditional bids and offers and not to indications of interest. The nature of the fixed income market does not lend itself to most pre-trade reporting. This is because pre-trade information could hypothetically include not only unconditional bids and offers but also indications of interest. However, indications of interest provide very little useful information and, due to the dynamic nature of the debt markets, are only meaningful at the point in time the indication is given. Not only are indications of interest far more common than unconditional bids and offers (which tend to only occur with smaller transactions), there is a risk that their disclosure would hinder the ability to complete trades and be detrimental to liquidity. In addition, pre-trade reporting would include bids and offers which are not made in the context of the prevailing market conditions, which could provide a misleading value for a security.

Question #3: What type of pre-trade information should be disseminated? Should it include indications of interest?

Please refer to the response to Question 2.

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?

If mandatory reporting is applied to government fixed income instruments, trade reporting should maintain the current one hour delay. Please refer to the response to Question 7 for further comments.

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?

No comment.

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?

Please refer to the response to Question 2, as well as to Appendix A for the currently available sources of corporate bond price information.

Question #7: Should the time for reporting the trades be reduced (for example, should all trades be reported and disseminated in real time)?

Mandatory reporting should maintain a one hour delay. Retail fixed income investors, due to their tendency to buy and hold bonds, do not require real time reporting. Institutional investors appear satisfied with the timeliness of current trade reporting.

Additionally, it will likely be operationally difficult for dealers and market participants to comply with an increased reporting frequency. It would appear that, at least at this time, any benefits that would be obtained by an increased reporting frequency would be outweighed by the costs that would incurred. Real time reporting is not currently possible from a dealer operational standpoint. The IDA is currently working with Member firms to ensure compliance with the one hour reporting requirement.

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

No comment.

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?

> As discussed throughout the IDA's response, the IDA is of the view that there has been sufficient progress regarding fixed-income transparency to date, particularly with respect to institutional investors. Although further progress may well be required with respect to fixed income transparency for retail investors, further research, analysis and review must be conducted before the most appropriate means of achieving effective transparency for retail investors can be determined.

<u>Proposed Changes to Best Execution Obligations in Companion Policy to NI 23-101</u>

The IDA also wishes to comment on the proposed addition of subsection 4.1(8) to Companion Policy 23-101CP. That section reads as follows:

> 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.

The IDA does not agree that the proposed amendment is a codification of a dealer's best execution obligations. Although the IDA advocates the implementation of a best execution regime for trading of all securities, the IDA is wary of any attempt at amending best execution regulatory requirements on a piecemeal basis. The regulation of best execution should be approached on a comprehensive basis, taking into consideration all relevant factors that inform and make up best execution, as well as all potential effects, both positive and negative, that may result from the implementation of either principles-based or bright-line best execution rules.

The proposed amendment to NI 23-101CP takes a rather bright-line approach which, if a dealer is to comply with the subsection and take into account order information from all marketplaces, in effect requires the dealer to ensure that its order information screens provide order data for each and every marketplace on which the securities in which it deals trades, regardless of the liquidity of those marketplaces. We are of the view that a marketplace should have a certain level of order flow before a dealer is required to access that market. Otherwise, a dealer would be required to have subscriptions to numerous information processors, information vendors and/or marketplaces, including those marketplaces where there is no demonstrated liquidity.

The proposed amendment is a potentially onerous and unnecessary requirement that may not in the end assist in obtaining best execution or provide a net benefit to the marketplace.

Furthermore, it may be more appropriate to address amendments such as this one in the larger context of best execution regulation as opposed to trade transparency.

Conclusion to IDA Response

The IDA recommends that the CSA, in the absence of any defined problem or market failure, maintain the status quo with respect to the mandated level and type of transparency in the Canadian fixed income market. Furthermore, the current exemptions from the government debt transactions reporting requirements should be extended for a further five years to December 31, 2011.

The above recommendations are based on several factors: 1) the Canadian institutional debt market has a satisfactory level of transparency; 2) industry-driven, market forces continue to increase the level of fixed income price transparency; and 3) the appropriate transparency level of the retail fixed income market is not yet sufficiently well known to justify regulatory intervention. Before issues regarding transparency in the retail fixed income market can be addressed, those issues must be sufficiently identified and delineated. The IDA is committed to obtaining the necessary information regarding the size and nature of the retail fixed income market, as well as to implementing retail debt instrument fair pricing rules.

Issues regarding pre-trade and trade transparency do not exist in isolation and must be considered in conjunction with other, broader issues such as best execution. Other initiatives such as those relating to best execution and TREATS may, when implemented, increase transparency and/or provide guidance on whether further transparency is required. It may well be more appropriate to deal with these other issues and initiatives before increasing, changing or mandating fixed income price transparency.

Thank you for the opportunity to comment on the proposed changes to the ATS Rules.

Yours truly,

Joseph J. Oliver
President and Chief Executive Officer

APPENDIX A

CURRENT SOURCES OF BOND PRICING INFORMATION[10]

<u>*CanPX*</u>

- All marketplaces, inter-dealer bond brokers and dealers trading in corporate debt are required to provide details of their trades on 63 designated corporate bonds to CanPX. CanPX displays for each trade, within one hour of the trade: the issue, type, coupon, maturity, price, yield, time of trade and volume traded.
- All IDA member firms trading in corporate debt with a de minimus market share of 0.5% of total corporate bond trading in designated corporate bonds are required to provide feeds to the CanPX display.
- CanPX coverage also includes benchmark Government of Canada Treasury Bills and Bonds as well as provincial debt instruments. This information is reported voluntarily by IDBs.
- There are almost 200 legal entities who receive CanPX data. Much of this data is then further disseminated to other parties.
- Access to CanPX data is available to institutional investors through vendor packages and to retail investors through a web-based product offered at a subscription of $50 per month for corporate bonds and $50 per month for government bonds.
- CanPX Inc. is considering making end-of-day benchmark Canada bond prices available free of charge on its website.

<u>*Gmarkets*</u>

- Gmarkets Inc. packages financial information, including CanPX pricing data, for smaller institutional investors.

<u>*Large information vendors*</u>

- Vendors such as Reuters, Thomson and Bloomberg display price information on bonds and money market instruments to their customers, which include retail brokers. Vendors such as Thomson and Bloomberg also provide inter-dealer and intraday prices.

<u>*ATSs*</u>

- ATSs provide institutional electronic trading platforms and increased transparency to institutions and retail advisors.

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[10] This list incorporates information provided by the Investment Industry Association of Canada.

- *CanDeal*
    - CanDeal consolidates indicative bid offer prices from participating market makers into a single real-time best price view of the market (including 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) and allows institutional investors to request and receive firm quotes from multiple dealers and execute trades on-line.
    - CanDeal carries pricing data for 300 bonds including all Government of Canada bonds and T-bills, a range of provincial and agency bonds and all the CanPX corporate bonds. The prices are updated continually throughout the day.
    - Investment advisors can access the CanDeal data through all the major market data vendors.
    - CanDeal data is also sold to vendors who provide the information via internet subscription directly to retail investors - $4.00 per month for real-time quotations or $1.00 per month with a 15 minute delay. For example, CanDeal provides real-time price information on the CanPX list of corporate bonds to Stockwatch, as well as Government of Canada bonds and treasury bills and provincial bonds.
    - CanDeal data is also sold through TSX DataLinx, a subscription service provided by the TSX.

- *Perimeter CBID*
    - Perimeter CBID shows the best bid and offer quotes from a consolidated feed throughout the day on approximately 1,500 government and 1000 corporate bonds.
    - The data is available through subscription to retail investors and investment advisors. Institutional offer quotes on 15 of its most active corporate bonds are provided for free on its website.

<u>*Discount brokerages*</u>

- A number of the bank-owned discount brokerages display a portion of their bond inventories to their clients via their online trading platforms.
- These online systems offer pre-trade transparency to those investors/clients that are sophisticated enough to browse the dealer’s inventory. Many of these systems display both bids and offers for transactions ranging from $5,000 to $1,000,000 in face value. The bids and offers displayed are indicative of what a retail client can expect to pay if a trade were executed at that point in time.

Other Sources

- *Internet sources*
    - Bond pricing information can be obtained from Internet-based services such as StockWatch.
    - Free closing rates for benchmark securities are included on the TSX website (http://www.tsx.com/HttpController?GetPage=BondsRates&Language=en) and Perimeter CBID (http://www.pfin.ca/product_cbid.asp) website.

- *Newspapers*
    - The national newspapers provide bond quotations, including closing prices and yields, as of the previous day's close of market for benchmark government of Canada bonds and most active corporate and provincial bonds.