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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

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Ontario Securities Commission
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Dear Members of the CSA;

**Re: PROPOSED AMENDMENTS TO NI 21-101 MARKETPLACE OPERATIONS, COMPANION POLICY 21-101CP, NI 23-101 TRADING RULES AND COMPANION POLICY 23-101**

On behalf of Scotia Capital Inc., please accept our comments in relation to the proposed amendments to the National Instruments and Companion Policies regarding Marketplace Operation and Trading Rules.

In reviewing these National Instruments, and the proposed amendments thereto, we recognized that certain rules and concepts applicable to the trading of equity securities may not lend themselves easily, and might not achieve the same regulatory objectives, if applied to the trading of debt securities. A single set of prescriptive marketplace operation and trading rules appropriate for both the equity and debt markets may not be practicable nor desirable in all respects given the very disparate characteristics and operation of these markets. We support a principle-based regulatory environment that fosters open and flexible market-driven solutions that are fair and efficient. In general, regulatory rules, where required, should be crafted to respond to rather than dictate the direction of market development, and should be reasonable and relevant to the particular market, carefully balancing the legitimate interests of all market participants.

## General Comments:

### Market Integration and Data Consolidation in the Equities Market

When the ATS Rules[1] were introduced in 2001, the CSA mandated the development of a data consolidator and a market integrator between marketplaces trading the same securities in order to mitigate fragmentation of the market. However, by 2003, there were no Canadian marketplaces trading the same equity securities. Thus, it was entirely appropriate for the CSA, upon the recommendations of the Industry Committee[2], to eliminate the regulatory requirement in the ATS Rules for the development a market integrator. The Industry Committee report recommended a market-driven solution to provide for data consolidation and market integration, stating that a more open model should be adopted.

While the Industry Committee recommended that a mandatory requirement for the development of a market integrator was not necessary, it recognized that in lieu a data consolidator of pre- and post-trade data would be required to facilitate best execution and market integrity in the equities market. The Committee's recommendation was premised on its understanding that access vendors and order management systems would be able to facilitate and provide a form of "system-enforced" best execution and other regulatory requirements on behalf of market participants using consolidated displays and direct marketplace access via their desktop terminals. Unfortunately, access vendors with innovative and sophisticated order-routing management systems have yet to materialize.

On October 14, 2005, the CSA held a public forum regarding trade-through obligations in a multiple (equities) marketplace environment. Investment dealers submitted that, absent the development of a market integrator, or alternatively a data consolidator and sophisticated order management systems, it would be more efficient and cost-effective to require new marketplace entrants to the Canadian equities market to interconnect with

[1] NI 21-101 and NI 23-101
[2] Industry Committee on Data Consolidation and Market Integration in Canada

the primary marketplace and to each other, and to allocate orders appropriately as between the marketplaces, rather than to impose this obligation on all dealers. A certain level of marketplace interconnectivity would be necessary to ensure certain efficiencies and characteristics of the Canadian equities market, such as a centralized electronic limit order book and market-enforced rules, would not be lost. It was also pointed out that the U.S. equities market had adopted an integrated marketplace model and it did not make a lot of sense for Canada to be moving in a different direction. We encourage the CSA to review and carefully consider those previous submissions.

*Please see our further comments below in response to Part G – Other Amendments – Companion Policy 23-101 – Best Execution Obligations of a Dealer; and Part G – Availability of Technology Specifications and Testing Facilities.*

**Transparency in the Fixed Income Market**

In considering the appropriate level of mandated transparency in the fixed income market, it is imperative to once again emphasize the distinction between the exchange-based "agency" structure of the equities market and the "dealer-principal" based structure of the bond market. Order and trade transparency requirements that make sense for trading equities may not make sense, nor achieve the same desired results, when imported to the fixed income market given the fundamental differences between these markets. While perhaps less overtly transparent than the equities market, the fixed income market is arguably just as efficient if not more so given the size of this market and the relative absence of client complaints or market integrity issues. It is also important to consider that increasing transparency requirements in the fixed income market will inexorably lead to a decrease in liquidity. Thus, it is important to achieve an optimal balance between transparency and liquidity. We believe the current "market-driven" level of transparency in government and corporate bonds is adequate and strikes a fair and reasonable balance between transparency and liquidity in the fixed income market without the need for regulatory intervention.

Regarding the four options proposed by CSA staff in relation to the transparency of government fixed income securities, we would support Option #2 which would extend the current exemption in NI 21-101 for a further five years. During that time period, developments in the government debt market both domestically and internationally can be monitored to determine whether a permanent exemption from transparency requirements is appropriate or whether increased transparency is required. We believe that if more transparency is desired, market forces will ensure an optimal level of transparency is achieved. In making our submissions, we have had the benefit of reviewing the IIAC's[3] comments and would fully endorse those submissions.

**A. Transparency for Government Debt Securities**

***Question #1***

[3] Investment Industry Association of Canada

***Should there be a mandatory requirement to report and disseminate information related to designated government debt securities? What are the benefits and disadvantages to this and the alternative approaches?***

Mandated reporting and information dissemination requirements for government debt securities are not necessary in our view. There is already significant and sufficient pricing transparency readily available from a variety of sources, including: (i) through direct communications between the buy-side and sell-side; (ii) information processors, such as CanPX; (iii) information vendors such as Reuters, Thomson and Bloomberg; and (iv) national newspapers across Canada. Closing rates for benchmark securities are available without cost on the TSX and Perimeter CBIC websites. Retail investors can readily access pricing information on designated government bonds from their full-service investment advisors or from discount brokerage websites. We believe the current level of transparency in government bonds is adequate to meet the needs of institutional and retail investors.

***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?***

Dealers should not be subject to order or trade transparency requirements for government bonds. In the principal-based fixed income market, price / yield information is a more relevant consideration for investors than order or trade transparency. Pre-trade order information in real-time is appropriate for the auction-driven equities market, but has little application or benefit to market integrity or efficiency in the debt market. Most institutional investors would oppose the mandatory display of their order information in real-time by dealers as this would have the effect of revealing to other market participants their interest or potential trading strategies in relation to those securities. Transparency of dealer's orders in real-time would pose similar confidentiality and liquidity concerns since many of these orders are undertaken to facilitate client orders. While increased order or trade transparency could theoretically narrow spreads, the potential benefit to investors is likely to be offset by a reduced willingness by dealers to provide capital, and in turn liquidity, in the market, which would potentially widen spreads. We would not support imposing mandatory order and trade transparency requirements on dealers in relation to government debt securities.

We believe considerable transparency of trade data on most federal and provincial government debt securities is already available from CanPX. This data is currently being provided voluntarily by dealers to Inter-dealer brokers ("IDBs") who in turn provide the information to CanPX. We believe an appropriate level of trade and volume data is already being provided to the market.

***Question #3***

***What type of pre-trade information should be disseminated? Should it include indications of interest?***

We would not support the dissemination of pre-trade order information as we believe there is little or no demonstrable benefit to investors or to the integrity of the debt market as a whole. Transparency of orders or indications of interest would disadvantage investors by revealing their trading strategies, drive up prices and negatively impact liquidity, with little or no corresponding benefit. We believe institutional investors in particular would be reluctant to provide order information or indications of interest to a dealer where such information would be required by regulation to be publicly disseminated. An appropriate amount of pre-trade information, in price and yield terms, is already publicly available through CanPX.

***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?***

For the reasons stated above, we would not support a regulatory requirement to disseminate order information in real time, nor would we support a requirement to report trade information within one hour of the trade. We question the feasibility of such a requirement, particularly during periods of increased market volatility. Fixed income markets cannot be halted to accommodate unexpected volume in the same manner as exchanges or electronic ATSs. In addition, institutional investors are unlikely to want exposure of order information in real time. Mandated reporting of all trades within one hour could have negative implications for market participants by disclosing sizable positions, trading activities and potentially revealing trading strategies, particular with respect to less liquid government bond issues. We believe the current market-driven timeframes for IDBs to report trade information on CanPX are appropriate, but should not be mandated by regulation. Market forces should be permitted to determine and develop the optimal level of order and trade transparency and the reporting timeframes.

***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?***

The volume caps set out in NI 21-101CP may not be appropriate when applied to government debt securities. For example, a $2 million cap could be appropriate for an Ontario bond whereas the same cap for a PEI or municipal bond may represent in excess of 10 percent of the entire issue. In our view, further tiering of volume cap for different types of government bond securities would add confusion and complexity rather than clarity for the average investor. For reasons stated above, we do not support the dissemination of trade data on government bonds except on a voluntary basis, as is the current practice.

However, if the CSA feels that, in the interest of protecting retail investors, certain trade disclosure in government bonds should be mandated, then we would recommend disclosure through IDBs of all government bond trades up to $200,000. This would represent the range most relevant to the retail market and comprises the typical range of trades that are automatically executed through a dealer's trading systems and not trader-managed.

**B. Transparency for Corporate Debt Securities**

***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?***

Currently, only marketplaces are required to provide order information for corporate debt securities to an information processor. We would not support imposing similar pre-trade order transparency requirements on dealers for the same confidentiality and liquidity concerns as discussed above in our response to Question #2. Mandated pre-trade transparency of order information could have the negative effect of revealing the trading strategies of market participants, including investors, and could increase the risk of trading or holding large positions in corporate bonds, particularly less liquid ones. We believe the current pre-trade transparency requirements on marketplaces only are appropriate and need not be amended.

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

Marketplaces, and IDBs and dealers executing trades outside of a marketplace, are all required to provide post-trade information regarding designated corporate debt securities to an information processor (i.e., CanPX) within one hour of the trade, subject to par volume caps. It would be extremely difficult, in our view, to reduce this reporting timeframe to real time. Real time reporting of all corporate bond trades may not be realistically achievable, particularly during periods of increased market volatility. We would be reluctant to support real time reporting of corporate bond trades unless there was a demonstrable benefit and demand for this by investors (which we have not seen) that would outweigh the anticipated costs and implementation hurdles. *[Also, please our response to Question #4, above.]*

**C. Designated Fixed Income Securities**
***Question #8***
***Has the process for designating benchmark corporate fixed income securities been effective? Please explain your response.***

We support the current methodology for designating benchmark corporate fixed income securities through CanPX. The methodology is transparent, inclusive of relevant market participants including investors, and provides greater flexibility than would a methodology mandated by regulation. This market-driven process has proven to be effective as evidence by the tripling of the number of designated corporate debt securities in the past three years and demonstrates the fixed income markets' ability and willingness to self-regulate.

***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?***

We believe there has been sufficient progress to date regarding fixed income transparency and see no immediacy for taking corrective action. Market forces rather than regulatory intervention have largely determined the appropriate level of transparency and reporting timeframes in the fixed income market and we expect will continue to do so in the future. As expressed in our opening general comments above, increased transparency must be balanced against the potential loss of liquidity. To our knowledge, there have been few concerns, if any, expressed by the institutional investing community with respect to transparency. Retail investors seeking information on designated government or corporate bonds can obtain pricing information through a variety of sources, including their investment advisor, newspapers and a variety of cost-free websites including the TSX and Perimeter CBIC. *[Please see our response to Question #1, above.]* We do not see order and/or trade transparency as an overriding concern for retail investors, rather, the suitability of a fixed income product is likely to be of paramount consideration. We believe regulatory efforts aimed at enhancing retail investor education of the risks, yields, maturities, coupons and other features of fixed income securities would be a more direct and effective way of protecting retail investors.

**D. Electronic Audit Trail Requirements**

We would strongly urge the CSA to consider working through electronic audit trail requirements in the equity market first, together with broader considerations of transparency, trade-through, access, best execution, etc., in a multiple marketplace environment prior to applying these same or similar concepts or requirements to the fixed income market. With the recent introduction of new equity marketplaces in Canada and the anticipated addition of more in the near future, it is more important at this juncture for market participants to concentrate efforts and to carefully think-through and work-through all of the implications of these significant proposed changes before pressing ahead with the fixed income market. To date, the fixed income market in Canada has been largely, and rather successfully, self-regulating with respect to reporting and record-keeping / audit trail requirements. We see no urgency for regulatory intervention in the fixed income market.

## E. Clarification of Best Execution and Other Obligation in a Multiple Marketplace Environment

When the Industry Committee published its report in 2003, it specifically recommended that the CSA develop and publish additional clarification of the meaning of best execution.

*"In the views of the Committee, a market-driven solution, augmented by clarification of best execution obligations, development of common standards on data consolidation, and unrestricted opportunity for connectivity between marketplaces, offers the most efficient, flexible and effective choice available available to Canada today."*[4]

UMIR 5.1 sets out a Participant's current best execution obligation in the equities market as follows:

*A Participant shall diligently pursue the execution of each client order on the most advantageous terms for the client as expeditiously as practicable under prevailing market conditions.*

Best execution is not equivalent to best price, rather it is more complex and includes consideration of a number of factors, including but not limited to speed and certainty of execution, depth of liquidity, confidentiality and cost of execution, including access costs. In absence of a way to market-enforce or system-enforce best execution in a multiple (equities) marketplace environment, a dealer should be able to determine how it will fulfill its best execution obligation in respect to its clients' orders. A particular dealer may determine that speed and certainty of execution are of paramount importance and will seek out those marketplaces with depth of liquidity. Another dealer may determine that it will seek out the best price in all marketplaces. Dealers would have to disclose their best execution policy to clients, including perhaps what marketplaces it is a member or participant of and what additional marketplaces, if any, that it will monitor and execute on via jitney. Investors/clients can choose which dealer it wants to execute equity trades with, based in part on the dealer's disclosed policy. If a client is not satisfied with a particular dealer's best execution policy, market forces dictate that the client will move its business to another dealer whose best execution policy is more aligned with its needs. Market forces rather than regulation should dictate how dealers formulate their best execution policies in a multiple marketplace environment taking into consideration the needs and objectives of their client base. The Industry Committee expressed, "*Best execution rules and market supply and demand should determine the means by which traders access a particular marketplace. Again, traders and firms should make best market determinations freely and have the option to choose how best to manage this process*."[5] We believe the above-proposed market-driven model best reflects the principles expressed by the Industry Committee in its 2003 report, and best achieves the

[4] Report to the Canadian Securities Administrators Market Structures Committee Industry Committee on Data Consolidation and Market Integration in Canada, March 7, 2003 (2003) 26 OSCB 4387.
[5] Supra.

regulatory objective of the ATS Rules - "to provide investor choice as to execution methodologies or types of marketplaces."

Dealers should not be mandated by regulation to have to manually seek out order information from all marketplaces, including marketplaces to which it is not a member, at least not until such time a market integrator or data consolidator of order information from all marketplaces trading the same equity securities is available. In addition, dealers should not be required by regulation to have to take steps to access orders on all marketplaces, including having to jitney orders to another dealer who has access to a particular marketplace. A nominally better bid/ask price on another marketplace may not result in best execution for a client after additional execution costs are factored in. A dealer may choose to do so in formulating its best execution policy, taking into account the additional costs, time, uncertainty, access, etc., however it should not be a mandated requirement. For this reason, we would not support the proposed amendment to the Companion Policy to NI 23-101, subsection 4.1(8). We would be open to revisiting this issue in the future should there be development of a market integrator, or alternatively an order allocation or routing system between interconnected marketplaces that can automatically and appropriately migrate orders from one marketplace to another. We would emphasize that the Industry Committee did not contemplate or recommend a regulatory requirement for dealers to have to access all marketplaces, or all orders on all marketplaces. We would suggest that the CSA consider striking another industry committee on an expedited basis to re-examine best execution, including execution and access costs, and trade-through obligations given the current technology available and the evolving multiple marketplace environment in Canada.

Finally, we would ask the CSA to consider that best execution as applied to retail client orders may not have the same meaning or treatment as for institutional client orders. We believe dealers should be permitted to craft their own best execution policies regarding retail and institutional client orders, provided dealers are not intentionally disadvantaging retail client orders and are pursuing the execution of those orders as expeditiously as practicable under prevailing market conditions.

With respect to the fixed income market, we would suggest that best execution has a very different meaning and application than in the auction-based equities market. It is difficult and perhaps inappropriate to apply the same concepts of best execution, multiple marketplaces, trade-throughs, etc. in a principal-based fixed income market. We would ask the CSA to carefully consider and clarify whether these concepts should apply to the fixed income market, and if they should, then how.

**G. Other Amendments**

**Exchanged-traded securities that are options or foreign exchange-traded securities that are options – Proposed deletion of exemption until January 1, 2007 so that transparency requirements will apply.** [Proposed amendments to NI 21-101, section 7.5 and Companion Policy 21-101CP, subsection 9.1(5)].

Rather than the deletion of this exemption, we would request an extension of this exemption as it applies to exchange-traded options or foreign exchange-traded options until there is greater clarity provided by the CSA as the specific impact of these transparency requirements on these types of securities. We note that in the Industry Committee's 2003 report, the Montreal Exchange asserted that data consolidation is not required for ATSs offering trading in options since options are not fungible between clearing organizations.

**Availability of Technology Specifications and Testing Facilities** [Proposed amendments to NI 21-101, section 12.3]

We strongly urge the CSA to expand these timeframes. We would suggest a new marketplace should be required to publish its full technology requirements and provide testing facilities for at least a minimum of six months prior to operating. We believe the proposed two month and one month timeframes are insufficient for investment dealers to properly test and potentially have to modify internal systems to accommodate each new marketplace entrant. It would be neither prudent nor appropriate to go live with potentially significant system changes without sufficient testing to assure client orders will not be compromised.

We further question why dealers should be required by regulation to have to expend resources, on short notice, to accommodate the entrance of every new marketplace, particularly where a dealer may not choose to become a member or participant of that marketplace and where the new marketplace may ultimately prove not to be viable. Marketplaces have a strong economic interest in ensuring a certain level of market integration or marketplace interconnectivity in order to facilitate their trades and to protect against orders on their marketplace from being traded-through. We submit that marketplaces, as opposed to dealers, should bear the costs of ensuring and determining its own level of interconnectivity with the primary marketplace and any other marketplaces it chooses to connect to, prior to going live. This market-driven proposal would better align development costs with potential benefits and would place the onus and choice of the degree of marketplace interconnectivity and order-routing allocation between marketplaces on the most appropriate market participant, namely the marketplaces. We would urge the CSA in the alternative to strike another Industry Committee on an expedited-basis to examine the cost-benefits and efficiencies of these various alternatives.

**Companion Policy 21-101CP**
**Clarification that marketplace information must include identification of the marketplace and other relevant information** [Proposed amendments to Companion Policy 21-101CP, section 9.1(2)]

We request the CSA clarify the implications of this proposed amendment. For example, we have already described to RS and OSC representatives the difficulty in specifying all

of the marketplace(s) on a confirmation to investors in situations where an equity trade may be executed in part on several marketplaces. It may not be feasible to identify all marketplaces on a single confirmation slip. On the other hand, the issuance of several confirmation slips relating to a single trade would be confusing to the investor. We propose that a confirmation relating to an equity trade that is executed in part on more than one marketplace should be required to simply state, “Multiple Marketplaces – details available upon request”.

With respect to the fixed income market, we are of the view that this provision does not apply.

**Companion Policy 23-101CP -** [Proposed amendment to Subsection 4.1(8)] Proposed amendment to the Companion Policy to NI 23-101, subsection 4.1(8), appears to equate best execution with best price, without adequate consideration to other best execution factors, such as cost of execution and access, speed and certainty of execution, confidentiality and liquidity and depth of the market for a particular security. In absence of a market integrator or data consolidator, there are costs associated with dealers having to manually monitor all orders on all marketplaces, including dark liquidity pools, after-hours markets, etc. There are also additional costs associated with accessing multiple marketplaces and executing orders on marketplaces where a dealer is not a member or participant and must jitney a client order through another dealer. In determining best execution, a dealer needs to be able to weigh these additional costs against other best execution considerations, such as speed, certainty of execution, etc. We would not support the proposed amendment to the Companion Policy to NI 23-101, subsection 4.1(8). We would be open to revisiting this issue in the future should there be development of a market integrator or alternatively an order allocation or routing system between interconnected marketplaces that can automatically and appropriately migrate orders from one marketplace to another. We would again emphasize that the Industry Committee did not contemplate or recommend a regulatory requirement for dealers to have to access all marketplaces, or all orders on marketplaces where they did not have access or were not members or participants.

*Also, please refer to our above comments in relation to Part E - Clarification of Best Execution and Other Obligation in a Multiple Marketplace Environment.*

In closing, we appreciate the opportunity to submit our comments and to participate in the review of these significant proposed amendments relating to both the Canadian equities and fixed income markets. We would be pleased to discuss these issues further with CSA staff and would invite you to attend at our premises to gain a better understanding of how our markets operate from a dealer’s perspective. Should you have any questions regarding our comments, please do not hesitate to contact Gina Yee at (416) 863-7459.

Yours truly,
Scotia Captial Inc.