

# **Inter Dealer Broker Association**

October 23, 2006

## **VIA E-MAIL & REGULAR MAIL**

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, Yukon Territory

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

Madame Anne-Marie Beaudoin  
Directrice du secrétariat de l'Autorité  
Autorité des marchés financiers  
800, Square Victoria, 22e étage  
C.P. 246, Tour de la Bourse  
Montréal, PQ H4Z 1G3

Dear Members of the Canadian Securities Administrators,

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**Re: Request for Comments on Proposed Amendments to National Instrument 21-101 Marketplace Operation, Companion Policy 21-101CP, National Instrument 23-101 Trading Rules and Companion Policy 23-101CP**

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## **II. BACKGROUND**

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### **1. IDB's Transparency History**

The members of the Inter Dealer Brokers Association (IDBA), Freedom International Brokers, Shorcan Brokers Limited and Prebon Canada Ltd are grateful for the opportunity to make comments on the Proposed Amendments. The members collectively account for 35% to 40% of the secondary bond market trading in Canada and have fully participated in the transparency discussions since 1987. The members of the IDBA have been shareholders and directors and have been contributing the best IDB prices to Canpx for public distribution from its founding in 1999.

Since the ATS Rules came out in 2003, the IDB's presented at the Bank of Canada Workshop on Transparency and Market Structure in February 2004 and participated on the Bond Market Transparency Committee (2004 – 2006).

The IDBA has consistently supported the purpose of the ATS Regulation "...to create a framework that permits competition among marketplaces while ensuring that trading is fair and efficient"<sup>1</sup>.

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## **III. SUMMARY OF REQUIREMENTS TO BE AMENDED**

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- 1. *Equity Securities- No IDBA comment***
- 2. *Government Debt Securities and Corporate Debt Securities***

The IDBA disagrees with the CSA proposal to change course and impose a new transparency regime.

- 3. *Electronic Audit Trail Requirements***

The IDBA supports the CSA's effort to increase information for regulators; however, such information systems need not necessarily change market structure. The IDBA recommends that the CSA increase its human resources and thereby reduce its dependence on technology for market information.

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<sup>1</sup> Notice of Proposed Amendments to NI 21 – 103....July 14, 2006

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## IV. SUBSTANCE AND PURPOSE OF THE PROPOSED AMENDMENTS

### *IDBA COMMENTS*

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#### **A. Transparency for Government Debt**

The IDBA disagrees with CSA proposal to impose a new transparency regime which effectively rejects the Bond Market Transparency Committee's recommendation and introduces a CSA mandated solution.

The CSA Notice of July 14 reviewed four options regarding transparency of government fixed income securities. This review and explanation does not acknowledge the progress of the last five years which has resulted in a tremendous increase in market transparency and it does not confirm that the consensus of the Bond Market Transparency Committee "the Committee" to extend the exemptions. CSA staff defined the mandate of the Committee "to provide advice and guidance to the Canadian Securities Administrators on any and all issues regarding the development and implementation of the Alternative Trading System Proposal which will increase the transparency, efficiency and surveillance oversight of the fixed income market..."<sup>2</sup>. As such, the IDBA is surprised the consensus of the Committee was not given more weight in the CSA decision to select an alternative proposal.

There exists a burden of proof for the CSA to demonstrate the need for market change. The record does not appear to provide evidence of market failure. The question that needs to be asked is; Does market failure exist and, if so, is the proposed solution an appropriate response to the failure.

Domestic "institutions are judged able to look after themselves in current conditions"<sup>3</sup> is a recurring theme in this discussion. There is also a consensus that transparency for the retail market needs to be improved. The IDBA concurs that regulators need the best quality of information possible. However, different segments of the market have different needs and likely require different solutions. It is the IDBA view that the centralized regulatory solution will not provide such flexibility and will impair creativity.

The source of the IDBA's concern about a regulatory mandated regime is that the solution likely will be wrong, will create less innovation and will increase centralization. The reason centralization is inherently wrong for the fixed income market is because of the segmented nature of the market itself. For example, the same bond can trade in different markets, at the same time, at different prices for perfectly legitimate reasons. Consider the dealer-to-client market where the price of a trade is linked to an underwriting responsibility, the dealer-to-dealer market where the price is linked to a required large size trade, or the retail market where the price includes the clearing cost of a small size trade, or the electronic market where the price reflects trader self-inputting of details and accepting risk of a wrong price.

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<sup>2</sup> M:\Market\_Reg\Markets\ATSS\ATS Fixed Income\Mandate of the Bond Market Transparency Committee.doc

<sup>3</sup> John Chant, Bond of Canada Workshop on Transparency and Market Structure, Feb 2004

Fragmentation (or specialization) has served the bond investor well and should be encouraged; a transparency regime that centralizes information is, by definition, an editing process that results in less information for the investor according to arbitrary editing rules. Specialization allows competition to occur between different market venues (marketplaces), while it reduces competition among specific orders - that is the trade-off. The IDBA believe the original purpose of the ATS Regulation, "to permit competition among marketplaces", provides direction on how to analyze such trade-off.

All participants in the transparency discussion are seeking, and will benefit from, a higher market quality. There is recognition that transparency is not the end, but the means to achieve higher market quality. However, optimum transparency is not equal to maximum transparency<sup>4</sup> and imposing transparency requirements will affect investor behavior<sup>5</sup>. The IDBA believes a cautious, market-driven approach, with regulator oversight, will best meet the objective of higher market quality. While market quality is affected by fragmentation (specialization) and transparency, market quality is determined by market risk.<sup>6</sup> A fundamental difference between the equity market and the bond market is the liquidity provided to the bond market through risk capital. Effects of transparency are complex and contradictory and, in the view of the IDBA, it is unlikely that a single regulated solution is best for the various segments of the market.

#### **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?**

The IDBA does not favour a mandated approach that defines what transparency model is best for the market. The preferred option would be for the regulators to establish the principle of increased transparency while leaving the design of the transparency systems to the market.

The benefits of a centralized system include equal access to consolidated information, and ease of control to help regulators monitoring process. The disadvantages include lost information due to the consolidation process, loss of innovation and specialization, and the de facto establishment of "price priority" in the bond market.

The alternative would be for all intermediaries to increase transparency for the client group they are servicing. In that way, the value of the information is enhanced and validated by the ability to trade.

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<sup>4</sup> D'Souza, Bank of Canada Workshop on Transparency and Market Structure, Feb 2004

<sup>5</sup> Ibid

<sup>6</sup> Shorcan, Bank Canada Workshop, Feb 2004

**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 be expected to be part of the solution and increase transparency of the Dealer-to-Customer market (institutional and retail). The IDBA does not believe the regulator needs to mandate any single solution.

**Question #3**

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

While being sensitive to the fact that compelling dealers to disclose information about a trade to the market could damage the market by increasing the risk of trading, any information that can be released should be released, including IOI.

**Question #4:**

**Are reporting timelines appropriate—i.e. order information is real time and trade information within one hour of the trade?**

With the roll out of STP technology timelines will become unnecessary.

**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 IDBA recognizes that volume caps are important and the proposed limits seem appropriate. However, we encourage the CSA to segment the information to the specific market segment—i.e. IDB information is for dealers, Dealer-to-Customer information is for investors.

## **B. Transparency for Corporate Debt Securities**

### **Question #6**

**Should we require pre-trade transparency for the corporate fixed income securities? If so, should the requirements be applicable to marketplaces only or should they also apply to dealers?**

A higher percentage of the corporate market relative to the government market is traded directly from dealer to customer without using marketplaces. The regulator should expect more information from dealers over time but should avoid designation of a specific solution.

### **Question #7**

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

The volume caps should allow for real time reporting of trades.

## **C. Designated Fixed Income Securities**

### **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?**

The domestic institutional market appears well served by the transparency of the bond market today. Technology has driven radical enhancement to the transparency of the market over the last five years, i.e. Canpx, CanDeal, Dealer systems, Bloomberg, CBID, ME Futures contract, etc. The IDBA expects the momentum of increased information will continue.

In regard to the retail market the IDBA has no comment.

## D. Electronic Audit Trail Requirements

The IDBA is not a participant of the Industry Committee on Trade Reporting and Electronic Audit Trail Standards (TREATS Committee). However, our general comments are that a technology solution such as TREATS needs to be scrutinized by a cost / benefit analysis. We note that even in the much larger US market, the development of TRACE (the TREATS equivalent) has been subject to criticism. Secondly, we note that Canadian regulators are seeking to achieve regulatory oversight objectives almost exclusively through technology solutions. The IDBA encourages the regulators to invest in human resources to enhance their oversight capabilities.

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

The IDBA strongly disagrees with the proposal to amend NI 23 – 101. The effect of the amendment is to impose a very narrow definition of “best execution” on the fixed income market. Specifically, the amendment defines best execution to be best price and then mandates where a principle must trade based on that definition.

The nature of a bond market is fragmented by variables such as client relationship, risk management, size of transaction, technology etc. (Please see page three of these IDBA comments). One of the economic reasons for the bond market segmentation is to achieve best execution for the principles that agree to the trade. Imposing a more narrow definition will not alter the nature of the market and will likely make it more difficult to trade and increase execution risk.

For some investors, best execution is best price, such as a retail investor; another investor will expand the definition of best execution to include both price and quantity; for a third investor best execution is price, quantity and consistency over a period of time. Only the investor can know what “best execution” for their circumstance is.

The objective of NI 21-101 is to encourage the development of multiple marketplaces as well as competition between marketplaces in Canada. It was envisioned that multiple marketplaces would evolve to serve specialized needs. Although it has taken years for marketplace concepts to be translated into live businesses, a number of marketplace ideas are about to become functioning marketplaces. The reason that multiple marketplaces can spring up has to do with the “best execution” concept itself.

In the AIMR Trade Management Guidelines (2002), the CFA Institute defines Best Execution as “*the trading process Firms apply that seeks to maximize the value of a client’s portfolio within the client’s stated investment objectives and constraints*”.<sup>7</sup> The Guidelines go on to suggest that “*determining the quality of trade executions entails the evaluation of*

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<sup>7</sup> AIMR Trade Management Guidelines (2002) at p.3

*subjective, objective and complex qualitative and quantitative factors*".<sup>8</sup> The Guidelines also contain the following commentary:

*"This definition recognizes that Best Execution:*

- *Is intrinsically tied to portfolio-decision value and cannot be evaluated independently,*
- *Is a prospective, statistical, and qualitative concept that cannot be known with certainty ex ante,*
- *Has aspects that may be measured and analyzed over time on an ex post basis, even though such measurement on a trade by trade basis may not be meaningful in isolation, and*
- *Is interwoven into complicated, repetitive, and continuing practices and relationships."*<sup>9</sup>

Regulation must avoid the trap of creating trading rules that interpret "best execution" too narrowly. The definition quoted above recognizes that "best execution" is multi-dimensional and should not be confused with "best price". For institutional investors and dealers, "size" and other variables impose significant, recurring constraints. "Best execution" and "best price" can be dramatically different things.

The IDBA is of the view that the bond market participants have overlooked the ramifications of this proposed amendment and encourage the CSA to review it with those who are engaged in the process.

Our final concern is that the amendment will reduce competition amongst IDB's and ATS's which is contrary to the objectives of the ATS Rules. A narrow definition of best execution reduces competition between venues because it compels trading activity based on the single criteria of price. It is our view the market will be served better, and the quality of IDB service will be enhanced through broad based competition.

On behalf of the members of the IDBA, Freedom International Brokers, Prebon Canada Ltd and Shorcan Brokers Limited, thank you for the opportunity to comment on the ATS proposals. We would be pleased to elaborate on these comments should you wish to get additional input from us.

Sincerely,

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For the IDBA (416) 360 - 2528

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<sup>8</sup> AIMR Trade Management Guidelines (2002) at p.2

<sup>9</sup> AIMR Trade Management Guidelines (2002) at p.3