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

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November 13, 2006

Mr. James E. Twiss
Chief Policy Counsel
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Market Regulation Services Inc.
Suite 900 – 145 King Street West
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Dear Mr. Twiss:

Re: RS Market Integrity Notice – Request for Comments – Provisions Respecting Competitive Marketplaces

This is a response by the Investment Industry Association of Canada (IIAC) to the request for comments contained in the above noted RS Market Integrity Notice 2006-19 and the subsequent guidance provided in RS Market Integrity Notice 2006-20.

In particular, this submission focuses on the changes to the best execution and best price obligations. Given that the proposed changes to the UMIR dealing with best price and execution were written in response to the CSA Notice of Proposed Amendments to National Instruments 21-101 *Marketplace Operation* and 23-101 – *Trading Rules* and their Companion Policies (the "CSA Notice") we also provide comments on the relevant provisions in that Notice.

Although the IIAC believes that requiring best execution through multiple marketplaces is an appropriate objective in principle, the practical realities of such a requirement must be carefully considered. We are concerned that the consequences of the proposed new rules will be to create significant disruption to, and create unintended negative effects on the Canadian capital markets and its participants. The impact of the new requirements have the potential to restructure the market in a way that may dramatically affect smaller firms, and ultimately the retail investor. As such, we believe that the CSA and RS should reconsider the implementation of the proposed regulations until the effects are reconsidered at a macro level.

Process Concerns

In addition to the content of the proposed rules, we are particularly concerned about the process that the CSA and RS have taken in implementing the provisions. The CSA clarification, and guidance issued by RS in various Market Integrity Notices have been published on a piecemeal basis, with little apparent coordination among the regulators, and without the opportunity for industry to provide meaningful feedback. These periodic notices containing "clarifications" and "guidance" actually contain substantive provisions that may result in significant changes to industry structure. At a minimum, they will require material changes to industry practices with no lead time for firms to develop systems for compliance.

By regulating through clarification and guidance, rather than through the required practice for rule and policy changes, the regulators sidestep the requirement for, and the opportunity to obtain industry feedback. Industry input is critical in determining the need for, and the practical implications of, regulatory changes. The result of regulating by interpretation is confusion in the market about the application of the rules. When regulations are subject to periodic revision without consultation, under the guise of providing clarification and guidance, it undermines market integrity and will increase inconsistent application and uncertainty about compliance.

What appears not to have been considered in the current situation is that in order to comply with the provisions in the CSA and RS notices, the industry must undertake significant and costly system and operational process changes. The problems of the costs and time required to comply are exacerbated by the fact that it is by no means certain that these changes are anything but transitory. As noted in MIN 2006-020, further changes to NI 21-101 and NI 23-101 (the "ATS Rules") may be forthcoming, and may require further guidance on trading and compliance practices and changes to UMIR. As such, the value of the investment required to comply with the CSA Notice, and the Market Integrity Notices is uncertain due to the possibility of significant modification to the requirements in the near future. It is impractical to expect businesses to invest time and money to comply with requirements when the regulatory bodies have not fully established a position or direction.

It is crucial that the CSA and RS first determine the objective, scope and details of the regulatory structure before it is imposed on the industry. In developing the regulatory structure, it is important to consult the industry. Market participants should only be required to undertake the time and financial expenditures that will allow them to comply once the objectives and details regarding compliance expectations are fully developed.

Content Concerns

As noted in the Market Integrity Notices, the following "clarification" of best execution obligations as set out in the CSA Notice provided the impetus for the changes to the UMIR.

"In order to meet best execution obligations, we [the CSA] 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."

It is the position of our members that this section represents more than a clarification. It is, in fact, a new requirement that is not consistent with existing industry practice. It has been the expectation of the industry that with the emergence of new ATSs, such a requirement would be imposed only coincident with the creation of a market integrator and data consolidator which would facilitate real time price comparisons and execution between various markets. In the absence of an integrator/consolidator, complying with this clarification may require dealers to subscribe to markets, or at a minimum undertake time consuming procedures to review pricing on other markets where they are not members, set up trading relationships and incur additional costs (related to purchasing and adapting technology to access and process trades from these markets) where there is no business case supporting it. Further, the intended beneficiary – the client- will ultimately be paying the costs for a procedure that may not bestow any benefits, and may, in fact work against best execution. These costs and concerns are magnified when the requirement to consider regulated markets outside of Canada are imposed.

The CSA Notice and Market Integrity Notices also work to create confusion about what constitutes compliance with best price and best execution obligations. The Market Integrity Notices specifically indicate that participants must reference the global marketplace in meeting obligations for best execution. However, notwithstanding the global market requirement for best execution, RS stipulates that the best price obligation would be satisfied if dealers have the capability to access market information and route orders electronically to the marketplace. The marketplaces identified as meeting these criteria are the Canadian stock exchanges and Pure Trading Inc. This apparent inconsistency raises a number of questions as to how to proceed when globally interlisted securities are involved.

Immediate Problem

The fact that the CSA clarification was deemed not to be a change to the existing regulatory regime causes a number of problems for market participants. These problems were highlighted with the release of RS MIN 2006-17, issued on Sept 1, 2006. This Notice adopted the CSA "clarification" effective immediately, and provided guidance on compliance.

One of the effects of the CSA Notice was to remove the consideration of whether a participant is a member, user or subscriber to a marketplace in determining reasonableness in relation to the best price obligations. The RS response was to restrict the application to markets that:

1. disseminate order data in real time and electronically through one or more information vendors;
2. permits dealers to have access to trading in the capacity as agent;
3. provides fully automated electronic order entry; and
4. provides fully automated order matching and trade execution.

This requirement raises a number of difficulties, the most significant of which relates to the immediate effective date of the Market Integrity Notice and the imminent start-up date for Pure Trading's continuous auction market. The RS notice indicates that Pure Trading will interlist TSX and Venture stocks in late November or early December. This causes a number of problems for market participants. First, as noted, in order to obtain the required information and trading access, dealers must either become members of Pure Trading immediately, or have access to real time trading information via TSX Datalinx. In addition, they must have access to the appropriate order routing technology to conduct trades on Pure Trading. Dealers will also have to develop systems and processes for compliance.

The short time frame until the Pure Trading launch will not afford dealers sufficient time to develop the appropriate internal systems and processes. More importantly, we understand that certain of the primary technology vendors supporting the dealers will not have completed the development of order routers until early 2007, making it impossible for them to comply with the requirements.

We strongly recommend that the CSA and RS hold this clarification and the resultant rule changes in abeyance until the process concerns outlined above have been dealt with, or failing that, the technology necessary for compliance is developed and available. As a general policy, CSA and IDA marketplace approval should only be granted if the ATS has the facility to make quotations and trade execution available through a market integrator / data consolidator.

Other Issues and Questions arising from the CSA Notice and Proposed Changes to UMIR

It is not clear what is driving this change to the current best price and execution guidelines. IIAC members are unaware of client complaints relating to best price or execution on interlisted securities. It is clear that the costs of complying with the changes will be material. As such, a demonstrable benefit should be evident, quantifiable and justifiable from a public interest and market integrity perspective, and it should be established that a real problem exists before enacting rules to fix it.

A number of possible negative consequences may result from the new requirements, some of which are detailed below.

Compromised Execution

The current process of arbitrage between markets has managed to address significant disparities in inter-market pricing for decades. If it is economically feasible to do so, the market evens out prices extremely well. As such, any price improvement that may result from the new requirement will likely be minimal, and offset by the increased costs to the clients. By removing the "information available to the participant from the information processor or information vendor" and "whether the Participant is a member, user or subscriber of the marketplace with the best price" as factors that comprise "reasonable efforts", potential areas for delay in execution are introduced. This is particularly true in the absence of a market integrator and data consolidator. We are concerned that the increased steps that dealers must undertake to discover and act on price differences will result in such delays, during which time the market may shift,

resulting in something other than best execution. In these situations, the advantages of canvassing multiple marketplaces may be lost due to the time required to do so.

If the fact that a dealer is a member or subscriber to a market is not a factor determining reasonableness in respect of best price and execution it must be clear that the costs of accessing the marketplace that will be passed onto the client should be factored into the reasonability standard.

Risk to Smaller Dealers

From a market structure perspective, the increased fixed costs inherent in this regulation will make it less likely that small firms can compete with large ones. This will effectively put many small dealers at risk and provide barriers to entry to the market. A reduction in the ranks of the small dealers would have a dramatic negative effect on price discovery, liquidity and the strength of the Canadian market, and will reduce the number of brokerage firms from which the Canadian consumer can choose.

Increased Client Costs

The proposal will undoubtedly impose additional costs that will be passed on to the clients of the surviving firms. Participants must pay for new information systems and undertake more trades through correspondent participants. Ultimately, clients will bear the cost of this new requirement, likely through increased sales commissions. Given that clients will be financing this "solution", they should be canvassed to determine if they agree that there is a problem to be fixed.

Less Competitive Marketplace

The impetus behind the ATS Rules was to foster competition among marketplaces to provide consumers with more options. The proposed requirements, however may have the opposite effect. The lack of a market integrator and data consolidator creates a captive customer base for ATSs which will be subsidized by dealers. Dealers will be required to pay to maintain some form of access to marketplaces they may not ordinarily patronize for any number of reasons. When marketplaces perform well, it is in the best interests of dealers to direct their trading to those markets. A rule that effectively mandates subscription or at least access to all marketplaces does not create performance incentives and may result in lower industry standards as clientele is guaranteed by regulation. It also limits the ability of firms to specialize in particular markets, which limits the choices available to clients.

The effect of the new provisions will also work to diminish the advantage of trading systems that draw centralized order flow. Markets compete for order flow on the basis of cost, speed, depth, service and support systems. Increased order flow fosters better liquidity and transparency, lower costs and better price discovery, all of which serve the interests of the average investor. Rather than fostering competition among markets, this proposal seems to undermine it by forcing participants to use markets that simply cannot attract the order flow on their own.

Effect on Order Management Systems

Market participants have invested heavily in automated order routing systems for Canadian marketplaces. These systems offer efficient order execution and provide excellent audit trails. If there is no proposed consolidated data feed or order routing system to access every ATS, trades will be subject to increased manual intervention as opposed to automated order routing. This will have a negative impact on execution speed, cost and the audit trail, and effectively undermine the effectiveness of these costly and efficient systems. In addition, if more manual intervention is required, it will work against the upcoming TREATS requirements to capture trade information and provide that information electronically to the regulators. Electronic trading systems are more compatible with the TREATS requirements (the required information is captured by order management systems). Manual tickets will require manual data entry on the dealer side.

Considerations at the Trading and Supervision Level

If more manual intervention is required, it is unclear how firms will monitor their best execution obligations. Will the regulators require that historical bid/ask information be publicly available from all relevant ATS's to conduct reviews? It is also unclear how an audit process for historical liquidity will be constructed.

Foreign Market Issues

The new provisions require dealers to check not only Canadian but all relevant foreign markets on which the stocks may be interlisted to achieve best execution. This is extremely problematic. Although the requirement is limited to markets where there is a reasonable likelihood of liquidity for each particular security, whether the market has reasonable liquidity may not be known without checking it first. In addition, the liquidity for a particular security on a particular market may shift over time, requiring dealers to have access to all markets to ensure compliance. From a practical standpoint, the reasonability standard is meaningless. The implication is that each dealer must purchase exchange feeds to view international markets in "real-time", and simultaneously, to verify, pre-trade, all pricing of the particular security in each of its trading markets throughout the world. The problem is compounded by the fact that securities will generally trade in non Canadian currency, requiring exchange calculations. In addition, the timing and execution of clearing and settlement procedures may not only differ, but introduce an element of uncertainty into the transaction. Ultimately, the time required to undertake the investigation and comparison of terms, combined with the uncertainty in dealing with foreign clearing and settlement procedures may cause delays or delivery issues that work against best execution. The problems inherent in requiring dealers to check foreign markets are so significant that compliance in the short to medium term is not feasible. Furthermore, the larger implications of routing business away from Canada to foreign markets should be considered. If foreign markets are to be included in the best execution obligations, a means to include them in an integrated system must be developed, and a means to deal with exchange rates and alternate settlement and clearing mechanisms must be addressed.

The effects of such a requirement on small independent brokers, introducing brokers and clients would be a magnified version of the issue described above.

Hours of Operation

MIN 2006-020 contains a provision that partially addresses the issues arising from differences in hours of operations of various marketplaces. The guidance issued in the MIN appears to have been developed without industry consultation and, like the other changes discussed in this letter, present compliance problems due to the lack of consultation and lead time for implementation. The guidance in MIN 2006-020 will also likely lead to client confusion, as it will be a challenge to communicate this guidance in plain language.

In respect of the issue of the extension of hours of operation, our members have expressed concern that a number of issues flowing from permitting extended hours have not been considered. Before this area is opened up, it should be acknowledged that extended hours of operation can have major implications in relation to compensation and/or increased staffing requirements for trading staff. Other functional areas, such as Compliance, Back-office and salespeople may need to move to extended hours as well, with corresponding implications. In addition, vendors as ADP have "End Day" processes that have to be started at a certain time each evening. If hours are extended, the normal end day processes within the firms will get compressed, perhaps unreasonably.

Similar considerations will apply to regulatory functions which operate in real time, such as market surveillance, continuous disclosure etc.

The cost and process implications of extending trading hours should not be underestimated, and as such, industry should be consulted before changes are implemented in this area.

General Comments

The problems highlighted above are primarily related to there being no market integrator and data consolidator underpinning the system. Requiring individual dealers to meet the proposed standards without such a centralized system is not practical and will result in much higher costs, inefficiencies and inconsistent standards in the market. Ideally, the presence and mandatory use of the integrator/consolidator would provide full transparency to all Canadian marketplaces and would provide order routing to the best available market. Until such time as such systems are developed, it should remain the responsibility of the dealer to inform their clients of the marketplaces of which they are participants. If clients perceive that they are disadvantaged by the dealer’s choice, they can make that known to the dealer through requests for access to other markets, or by moving their accounts.

We are also concerned about the interpretive nature of the proposed rules. The CSA clarification and RS reaction appear to set up a situation where the UMIRs are applied inconsistently for different marketplaces. This impedes fair competition.

Recommendations

Until a data consolidator/market integrator is in place, and the CSA and RS have established a coordinated strategy relating to multiple marketplaces, we recommend that the CSA and RS Inc repeal the proposed clarification in the CSA Notice and the related RS requirements in the Market Integrity Notices. It is crucial that industry be consulted in developing this strategy. Until that time, the CSA and RS should continue with its past "principles based" approach to best execution, and apply rules only to those marketplaces that a dealer has made a business decision to access.

If the CSA and RS are unwilling to delay the implementation of the provisions until the creation of a data consolidator/market integrator, the CSA "clarification" should be put out for comment and subject to the full regulatory process that is required when a rule or policy is amended. As noted, we are of the view that the clarification is, in fact, a significant change to existing requirements and practice, and given the potential impact on the market, should not be implemented without the benefit of public comment.

If the CSA and RS elect not to repeal or delay the clarification and provisions in the Market Integrity Notices, enforcement of the CSA and RS requirements should be delayed until such time the proper information and technology is available to permit dealers to comply.

Thank you for considering our input. If you have any questions, please do not hesitate to contact the undersigned.

Yours sincerely,

cc: David Wilson, Ontario Securities Commission
Doug Hyndman, British Columbia Securities Commission
Bill Rice, Alberta Securities Commission
Jean St. Gelais, Autorité des marches financiers