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July 19, 2007

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

Mme. Anne-Marie Beaudoin  
Directrice du secretariat  
Autorité des marchés financiers  
800, Square Victoria, 22e étage, C.P. 246, Tour de la Bourse  
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Mr. James E. Twiss  
Market Regulation Services Inc.  
Suite 900, 145 King Street West  
Toronto ON M5H 1J8

Dear Sirs and Mesdames:

**RE: PROPOSED AMENDMENTS TO NATIONAL INSTRUMENT 23-101 AND  
CONSEQUENTIAL AMENDMENTS TO THE UNIVERSAL MARKET INTEGRITY RULES —  
REQUEST FOR COMMENT**

Canadian Trading and Quotation System Inc. ("CNQ") appreciates this opportunity to respond to the above-noted request for comments. We commend the Canadian Securities Administrators ("CSA") and Market Regulation Services Inc. ("RS") for proposing a framework of rules for trading in a multiple-marketplace environment and our comments should be read in that light.



In formulating rules governing trade throughs and best execution, it is important to bear in mind the principle "first, do no harm." To a large extent, the marketplace is responding to the community's requirement for tools to assist in execution management and trade through avoidance through the provision of customized Canadian "smart" order routing technology from a number of vendors and the delivery of consolidated Canadian data services. The reality is that best business practice has supplanted anticipatory concerns and so we should take care not to implement solutions to problems that no longer exist.

The CSA and RS are proposing new regulations to address issues that have largely been solved by the Canadian capital markets as a whole at considerable effort and expense. The capital markets developed these solutions because the regulatory and business objectives are aligned – a dealer has a duty of best execution to its clients and will want to provide the best possible service to those clients. To artificially break the underlying chain of accountability within that relationship would defy both business and common sense and lead ultimately to unsatisfactory results.

### ***The Industry is Adapting to a Multiple Marketplace Environment***

To repeat our submission to the CSA in response to Notice 21-305, the landscape has changed greatly in the past year on both the order entry and market data fronts.

At least one Toronto-based vendor is offering access to a service bureau purpose-built to deliver smart order routing technology. Several vendors and dealers have contracted with this party to send order flow from their order entry and management system products into the marketplaces via the smart order router. This same vendor is licensing the technology to a number of dealers and vendors for integration into proprietary systems. In addition, to CNQ's knowledge, the other vendors providing marketplace access services to Canadian dealers are all in the process of delivering smart order routing capabilities to their customers. It is CNQ's belief that all order flow reaching the Pure Trading marketplace following launch of the continuous auction market service will, at the option of the entering dealer, be intermediated by smart order routing technology that will route orders to the marketplace with the best price.

The principal market data vendors in Canada are in the process of obtaining access to the data services of the marketplaces that exist or will launch shortly. Once the regulatory direction is clear, and the client base specifies the range of required services in response to the regulatory direction, CNQ believes that the vendors will be in a position to deliver the required screen display services in a relatively short period of time. As submitted by CNQ in response to Notice 21-305, authorizing one or more official "information processors" to consolidate data will not accelerate this process (it will be up to the vendors and their clients how the data is represented on the screen displays), nor will, as a result of important differences in technical interface, network configuration and geographical dispersion, creation of an information processor create the "level information playing field" envisaged by advocates of the concept.

### ***Trade Through Avoidance***

The proposal correctly notes that trade-through and best execution, while related, are distinct obligations. The first is an obligation of a participant to the Canadian marketplace as a whole, while the second is an obligation of the dealer to its client. We agree that it is an appropriate starting principle that better priced orders on other marketplaces should not be traded through. Protection of better-priced orders is a key contributor to market quality and efficiency as it provides an incentive to provide visible liquidity.

The proposal would put responsibility for preventing trade-throughs on the marketplaces. This could be achieved through technology (by routing the order to the marketplace with the better price, rejecting an order that would trade through another marketplace or queuing them at the price on the other marketplace), providing "best market" guarantees of execution, or through the marketplace requiring participants, as a condition of marketplace participation, to have policies and procedures designed to prevent trade throughs.<sup>1</sup> In addition, marketplaces would have to allow apparent trade-throughs by "sweep" orders where the participant has assumed responsibility for compliance, which adds complexity to trading systems as they process incoming orders.

It should be remembered that the US precedent being emulated by the CSA proposal emerged from a markedly different operating environment that had unique structural and technological impediments. Viewed by today's standards, the solution implemented in the US, the Intermarket Trading System, is an archaic and cumbersome tool that is being bypassed through the provision of "routing away" services by ECNs and through the implementation of execution management systems by market participants. Canadian regulation should anticipate these trends instead of stifling their development.

CNQ is concerned that the current version of the trade through proposal was motivated, at least in part, by the theory that effectively mandating creation of linkages among the marketplaces offering pre-trade transparency would be more cost effective and efficient than the alternative of requiring the dealers to develop and manage linkages to the different marketplace venues. CNQ submits that the appropriate policy direction is to preserve the trade through avoidance obligation on the dealers:

- The access vendors will be providing connectivity to all of the marketplaces, with the option (available at the dealer's discretion) of having the order distributed and managed through a smart order router.
- Increasingly sophisticated execution management systems (widely used in the US markets) will be implemented by dealers to take care of orders booked on a particular marketplace which become "executable" on another venue as a result of changing market conditions. It is the experience of users in the US markets that these systems operate far more efficiently than the cumbersome systems and structure implemented for the Intermarket Trading System amongst the exchanges.
- It is unreasonable to expect, in the current competitive environment, that the ATSS and exchanges will be able to cooperate to the degree required to implement the necessary linkages in a timely or cost effective fashion.
- Any attempt by a marketplace to reject, reroute or book a tradeable order will result in increased latency, compromising best execution. In the time it will take to manage the order, the better-priced order on the other marketplace may be filled and a trading opportunity missed.
- It is unlikely that a market maker will be willing to offer a best market guarantee to all orders entered on a particular marketplace. Any such guarantee will most likely be for orders under a certain size, similar to the Minimum Guaranteed Fill on the TSX. It is also unlikely that a dealer would offer such a guarantee in fast or volatile markets as it would be unable to properly manage its risk.

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<sup>1</sup> It is unclear the extent to which an ATS could do this, given that their ability to impose rules on subscribers is limited to trading on that marketplace, while this would be a general rule requiring a trade to be made on another marketplace. See National Instrument 21-101 §1.1 (definition of "alternative trading system").

- If a business opportunity exists for a marketplace to broaden its offering by delivering “routing away” services to customers, such activities should not be discouraged by the regulation.

CNQ believes that, in the event that the proposed trade through avoidance policies are adopted, the only practical response will be for CNQ to require participants to have reasonable policies, procedures and systems to avoid trading through better prices. It is preferable that the order routing decision be made *before* the order hits any marketplace. This will also eliminate the need for marketplaces to make the changes required to accommodate sweep orders.

We believe that participants will want to take this approach in order to ensure prompt execution of their orders at the best possible price, which is why they will be using “smart” order routers when the Pure Trading marketplace launches.

Our response to the specific questions follows:

- 1. In addition to imposing a general obligation on marketplaces to establish, maintain and enforce written policies and procedures to prevent trade-throughs, would it also be necessary to place an obligation on marketplace participants to address trade execution on a foreign market?**

The proposal asks whether participants should be required to fill better priced orders on Canadian markets prior to trading in a foreign market. We agree with the concern that participants may intentionally trade-through better prices on Canadian marketplaces by routing orders to foreign markets. However, the only effective solution results in a duplication of efforts – participants would still have to have procedures and tools to avoid trade throughs even if the marketplaces implemented a technological solution for trade through avoidance in Canada. This demonstrates the impracticality of putting responsibility for compliance on marketplaces.

- 2. What factors should we consider in developing our cost-benefit analysis for the trade through proposal?**

At a minimum, the analysis should consider the solutions that are available to avoid trade-throughs today and the impact on efficient order execution that would be caused by the proposed solutions. In addition, the analysis should look at the percentage of sweep orders that are entered on US markets. If the percentage is high, this indicates that the bulk of US dealers have assumed responsibility for compliance with the trade-through rule notwithstanding that it is a market responsibility, presumably because they are concerned about latency and an exposure to best execution concerns.

- 3. Would you like to participate?**

CNQ wishes to participate in the cost-benefit analysis.

- 4. Should trade-through protection apply only during “regular trading hours”? If so, what is the appropriate definition of “regular trading hours”?**

Trade-through protection should apply to all marketplaces that are open for continuous trading at any given time. If a marketplace is closed, it can be ignored, but there is no reason to suspend trade-through protection if two marketplaces are open after the principal marketplace is closed.

If one marketplace is open for continuous trading and another marketplace is in a pre-opening, fixed price or call mode, there should be no trade through obligations on either marketplace. A dealer's best execution analysis will determine the marketplace on which a client order should be entered.

**5. Should the consolidated feed (and by extension, trade-through obligations) be limited to the top five levels? What is the impact of the absence of an information processor?**

As submitted in response to Notice 21-305, CNQ believes that market data services providing full transparency across marketplaces offering pre-trade transparency will be provided whether or not an information processor is authorized by the CSA. In principle, protection should be offered to orders to the full depth of the book. There is no rationale for protecting only a subset of orders.

**6. Should there be a limit on the fees charged on a trade-by-trade basis to access an order on a marketplace for trade-through purposes?**

To a large extent this should be self-regulating; a marketplace that charges high fees will likely not attract many orders. It will also add considerable complexity, as trading fees may vary depending on whether the participant has reached certain trading thresholds. It would be preferable to take no action at this time but to monitor developments to determine if there is in fact a problem that needs to be addressed.

**7. Should the CSA establish a threshold that would require an ATS to permit access to all groups of marketplace participants? If so, what is the appropriate threshold?**

National Instrument 21-101 and its companion policy provide that an ATS must notify the commission if its market share is above 20%, at which time the commission may determine that it should be considered as a stock exchange with open access. This addresses concerns about all participants' ability to access significant liquidity pools.

**8. Should it be a requirement that specialized marketplaces not prohibit access to non-members?**

We do not believe that a trade through avoidance obligation should be limited to marketplaces of which a particular participant is a member. That creates a powerful disincentive to join new marketplaces as compliance burdens will increase. However, we believe that an ATS should be able to set its own "membership" criteria, subject to the requirements in National Instrument 21-101 that it not be arbitrary or discriminatory. If certain participants are excluded from membership, they should be permitted to trade through better prices on the ATS. *We emphasize that this exception must be limited to marketplaces which a participant cannot access because it does not meet the criteria for access rather than marketplaces for which it meets the access criteria but chooses not to access.*

**9. Are there types of special terms orders that should not be exempt from trade-through rules?**

Typically, "fill" terms (all or none, minimum fill, and lots of) other than odd lots were not allowed to execute at prices inferior to those in the regular market. There is an argument that this should be permitted as trades may be prevented (e.g. two all or none orders for

25,000 could not trade if there was an order for 100 shares at a better price). However, there is a danger that fill terms will be added to trades to avoid the displacement obligation. We believe that the ability for a fill term order to trade through a better-priced order on another marketplace should be consistent with how it is treated within a market and any exemptions for marketplaces with larger minimum order sizes. This is discussed further in our answer to question 14.

“Settlement” terms (cash, delayed delivery, etc.) and odd lots currently are allowed to trade at prices inferior to those in the regular market and should be exempt from the trade-through rule.

**10. Are there current technology tools that would allow monitoring and enforcement of a flickering quote exception?**

As noted below, if the regulatory focus is on a participant’s compliance procedures and tools rather than preventing all trade-throughs, it will not be necessary to have a flickering quote exception.

We have not examined this issue but we believe that it would be possible to develop a non-real time monitor at RS that would compare time stamps of orders and trades. Trade through violations will be rare due to the use of smart order routing systems and those that do occur will be inadvertent and likely unavoidable, so it probably will not be necessary to develop such tools. We would further suggest that this is another instance of where it would be best to initially monitor the reality of a multi-market operating environment in order to ascertain if this will actually even be a material issue that warrants any such development work.

**11. Should the exception only apply for a specified period of time?**

This issue again demonstrates the impracticality of requiring a marketplace to enforce the rule. The number of orders (and quotation changes) per second is accelerating in the Canadian equity markets, and will increase at a faster rate with the arrival of the new marketplaces offering competitive continuous auction market services. Even with the best technology and the utmost good faith, trade throughs will occur as markets will change while an order is being entered by a participant or processed by a marketplace. Even if there is one (or more) officially recognized provider of consolidated market data, all participants (and marketplaces) will not receive updated information at the same split second. Attempting to monitor when a “fast market” can be declared or how long it may last will require the development of expensive compliance and recordkeeping tools and no doubt will hinder efficient execution. It also will likely not be necessary – in a true fast market, the better-priced order will in most if not all instances be quickly filled by another market participant or be re-priced.

Rather than focus on the goal of eliminating trade throughs altogether, the regulatory regime should accept that they will happen inadvertently from time to time, notwithstanding the best efforts and intentions of all marketplace participants. The rules should require that participants have reasonable policies, procedures, technology and access to market data to avoid trading through. The test should be what a participant did with the available information at the time the order was entered, and whether the participant has taken good faith steps to evaluate information from marketplaces offering pre-trade information to avoid trading through better priced orders. This is also the test for determining whether a dealer has performed a reasonable best execution analysis.

**12. Should the [after-hours] exception only be applicable for trades that must occur at a specific marketplace's closing price?**

See our answers to questions 4 and 14.

**13. Should a last sale price order facility exception be limited to any residual volume?**

See our answers to questions 4 and 14.

**14. Should trade-throughs be allowed in any other circumstance?**

It may not be practical to apply the rule to marketplaces with significantly different trading methodologies. For example, an ATS with a minimum order size of 25,000 should not be required to accept an order for 100 shares to fulfill a trade through avoidance obligation. If the marketplace accepts the smaller order, there should be no exception. Similarly, a marketplace may operate as a periodic call auction rather than a continuous one. Such determinations will necessarily have to be made on a case-by-case basis rather than set out in a rule.

***Best Execution***

We agree with the CSA and RS that best execution comprises a number of factors in addition to price and that these should be set out explicitly. Rather than respond to each question, we wish to make some general observations.

The proposal suggests that dealers should consider all marketplaces within and outside of Canada in making a best execution analysis. We believe this is too broad. A dealer may not know all of the marketplaces on which a security trades, may not have access to the relevant market information, and may not be able to execute an order on a foreign market at an acceptable cost. Furthermore, settlement practices in foreign markets may be such that settlement is unreasonably delayed or expensive.

We think that the requirement should be refined to apply to situations where a dealer is currently accessing the foreign market. A dealer holding a client order should be prohibited from trading as principal in a foreign market and immediately unwinding to the client at an inferior price.

The proposal also asks whether marketplaces should be required to periodically report on order execution and market quality, and cites Rule 605 under the Securities and Exchange Commission's Rule NMS as precedent. We believe that this will be cumbersome and time consuming. A cursory review of the reports provided by the US exchanges quickly establishes the point that the rule has not resulted in the provision of any meaningful information for dealers and investors.

Rule 605, although prophylactic in scope, was originally designed as a response to abuses in the Nasdaq market. Client orders were not displayed and could be traded through by market makers. Even on the exchanges, public information displays were limited to the best bid and offer, and significant "hidden" liquidity might exist on the floor. In return for payments, dealers would agree to route all of their retail orders to a particular Nasdaq market maker or specialist on a regional exchange; on an order-by-order basis no analysis was done as to whether the order might receive better execution with another market maker or the exchange on which the security was listed. Rule 605 was designed to

provide consistent, objective information against which dealers would have to justify their market maker/specialist preferencing decisions to their clients.

The US approach was from a technology-challenged time. With today's electronic trading, any discrepancies or opportunities arising between visible ("light") markets will be acted upon in milliseconds. The light marketplaces have become one collective liquidity pool. Furthermore, the participants who are most concerned about execution quality monitor it on a real-time basis and incorporate their analysis into their order entry algorithms.

Canadian marketplaces are starting with more transparency on both a pre- and post-trade basis, which makes it a simple matter for dealers and their customers to assess execution quality on a trade-by-trade basis. Investors will be able to see prices at which a security is trading on all marketplaces and will question their dealer if they believe they got a bad fill.

We appreciate this opportunity to comment. In closing, we reiterate our support for trade-through protection and enhanced best execution criteria. However, we caution the CSA and RS, when finalizing these rules, to keep an eye to the future and not inadvertently enshrine the obsolete. A principled approach is preferential to a prescriptive one, particularly in circumstances where innovation and market forces are aligned to create efficiencies that will benefit investors.

We believe that the rules should be consistent with the underlying principles of

- (i) encouraging and protecting the price discovery process by protecting better-priced orders;
- (ii) aligning best business practices and regulatory requirements to the fullest extent possible; and
- (iii) preserving and strengthening the integrity of the basic fiduciary obligations due investors by maintaining dealers' accountability to their clients with respect to meeting best execution responsibilities.

Please direct any questions regarding this letter to me at 416.572.2000x 2282 or by e-mail to [Timothy.Baikie@cnq.ca](mailto:Timothy.Baikie@cnq.ca).

Yours truly,

**CANADIAN TRADING AND QUOTATION SYSTEM INC.**



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