

October 13, 1999

British Columbia Securities Commission  
Alberta Securities Commission  
Saskatchewan Securities Commission  
The Manitoba Securities Commission  
Ontario Securities Commission  
Office of the Administrator, New Brunswick  
Registrar of Securities, Prince Edward Island  
Nova Scotia Securities Commission  
Securities Commission of Newfoundland  
Registrar of Securities, Northwest Territories  
Registrar of Securities, Yukon Territory  
Registrar of Securities, Nunavut

c/o Daniel P. Iggers, Secretary  
Ontario Securities Commission  
20 Queen Street West  
Suite 800, Box 55  
Toronto, Ontario M5H 3S8

- and -

Claude St. Pierre, Secretary  
Commission des valeurs mobilières du Québec  
800 Victoria Square, Stock Exchange Tower  
P.O. Box 246, 22nd Floor  
Montréal, Québec H4Z 1G3

Dear Sirs/Mesdames:

**Re: Alternative Trading System Proposal**

The Institutional Equity Traders Association, the Montreal Institutional Equity Traders Association Inc. and the Vancouver Security Traders Association welcome this opportunity to jointly respond to the Canadian Securities Administrators' request for comments with respect to the Alternative Trading System Proposal.

Our associations represent approximately 700 institutional traders in the Canadian marketplace. It is important to recognize that while share ownership by institutional investors represents roughly 85% of the dollar value traded transactions on the Canadian Stock Exchanges, not all orders transacted by institutional traders are traded in large blocks. Our trading activity is also composed of many thousands of smaller orders which represent millions of individual investors and pensioners participating in the stock exchange through mutual funds, pension plans and administered RRSPs. For example, pension plans alone represent 2.5 million Canadian workers and over one million retired (or deferred) plan members. As such, we represent the interests of institutional investors as well as individual investors.

## **Overview**

Our associations believe strongly that the first priority for securities administrators should be the preservation of a strong, centralized, Canadian capital market that will provide a fair, liquid and transparent market for all Canadian investors. We recognize that market integration with new competitors such as ATSS will help to promote these objectives in the appropriate circumstances. However we also believe that the Canadian market, in its current form, must first regain its competitive advantage in the global marketplace before new forms of competition are introduced from within.

The background paper to the Request states that “the challenge is to incorporate new competitors into a regulatory structure that takes advantage of the benefits offered by technology while preserving the fundamental value of a strong centralised market”. We agree. In our view, it is essential that the Canadian Securities Administrators (CSA) focus on promoting a strong and stable centralized market prior to adding new competitors. It would be especially hasty to introduce new competition during the current realignment of the stock exchanges and the resultant uncertainty with respect to the regulatory regime for the oversight of existing exchanges.

We are also concerned with the level of detail with which the CSA proposes to achieve its proposed goals of market data consolidation and trade integration. The new regime for the regulation of existing markets will clearly incur significant costs and create serious obstacles for present market participants. We believe that there has been insufficient consideration given to the significant detriments that would be caused by these changes.

We propose to separate our submissions into two categories. We will first provide our general comments on market integration and the role of ATs in the unique Canadian market. We will then set out our specific comments and concerns with respect to the proposed instruments and trading rules.

## **General Comments**

### **The Canadian Market**

John Carson, the senior vice-president for market regulation at the TSE, recently stated that it is essential that the Canadian market continue to have a visible, significant exchange to act as a dominant pricing mechanism. We agree that the Canadian market must be protected in order to promote Canadian investment, and a unique Canadian market identity. Canada currently enjoys a strong, competitive capital market which plays an instrumental role in generating capital for the Canadian economy. If the introduction of ATs into the Canadian market reduces its competitiveness or efficiency, there is no shortage of accessible US markets for Canadian investors to turn to. As such, any changes to the Canadian exchange market should ensure that its autonomy and appeal to Canadian investors is maintained. Otherwise, pricing mechanisms for Canadian issuers will move south of the border.

Indeed, the importance of maintaining a distinct Canadian system is recognized in other sectors of the Canadian financial market. The mutual fund industry provides a good example of steps being taken to ensure a healthy and beneficial investment resource for Canadian investors and industry alike. Policies that prevent US mutual fund companies from soliciting business in Canada, forbid advisors to recommend US funds to Canadian clients, and prevent the distribution of US mutual funds without filing a prospectus in Canada, all serve to protect the Canadian mutual fund industry. Severe tax consequences also deter Canadian investors from investing in US mutual funds.

A large part of the rationale behind these policies is that Canadian mutual funds would not have reciprocal access to the US market. The result of Canadians being denied access to the US mutual fund industry is the existence of a healthy and productive mutual fund industry in Canada that benefits the Canadian economy.

In contrast is the multi jurisdictional disclosure system (MJDS) which has promoted reciprocity between the Canadian and US marketplaces for almost ten years. However, this system, which allows Canadian

issuers access to U.S. capital markets using Canadian documentation in certain circumstances, is in danger of being severely curtailed or eliminated by the SEC as suggested in its recent Aircraft Carrier release. This move away from providing reciprocal treatment to Canadian issuers in comparison to other international issuers suggests that the US may no longer be as interested in pursuing mutually beneficial relationships through the North American marketplace. As a result, we should be wary of those features of the proposed ATS regime that might drive Canadian investors to the US marketplace.

### **Lessons from the US experience**

The Notice states that the purposes of the new information transparency and market integration requirements is to preserve the benefits of a centralized market by taking advantage of technology. The US experience since the integration of ATSs in the marketplace illustrates that this can be a difficult balance to maintain. Recent commentary on the US market suggests that while the arrival of new competing trading systems has resulted in certain benefits, mainly lowering the cost of executing a trade, there have also been distinct disadvantages. The biggest loss has been the visibility of trading information to all interested investors. As a result of the existence of numerous competing, but disconnected marketplaces, individuals buying and selling stocks may not necessarily be getting the best prices on their trades.

Recent comments by the chairman of the SEC support the view that a centralized information system (rather than a computerized trading system) should be the priority. Arthur Levitt has called for the development of technology that will allow information about orders and transactions across the entire market to be available in one location for all investors to access. This is a shortcoming of the current US system. As a result, the increased competition afforded by ATSs has been offset by the decreased transparency of trading information.

We believe that a strong Central Limit Order Book must be established in order to prevent further market fragmentation in the Canadian market. This system should be the first priority of the CSA and should be put in place before outside competition from ATSs is introduced. We suggest that the possible benefit of lower execution costs through the introduction of ATSs would be outweighed by the lack of market transparency that would result. As such, we believe that the focus should be on preparing the marketplace to make complete trading information available to the public prior to increasing the number of sources of such information.

## **Specific Comments**

### **1. The Regulation of ATSS**

Our associations do not intend to state a position on the proposals for a regulatory regime for ATSS. However, we believe that these proposals should include the establishment of a Central Limit Order Book which will thereby reduce any danger of potential market fragmentation caused by a separate regulatory regime for ATSS.

### **2. Data consolidation**

We agree that all market participants should have access to full and complete information concerning the securities that they wish to trade. However, we are concerned with the prescribed information under National Instrument 21-101 and the Consolidation Plan. In particular, we do not believe that the prescribed information should be the only information that a marketplace can provide the consolidator for display.

In the first place, we do not agree with the removal of broker numbers from the prescribed information. We believe that the omission of this information will decrease information transparency and competition for all market participants. The ability to source liquidity using broker numbers is a daily necessity in the Canadian market where many thinly traded stocks exist. Broker numbers promote competition in the marketplace as institutional traders are able to seek out the most competitive offers for block trading. As well, the display of broker numbers plays an important marketing and business enhancing role for the Canadian brokerage community. While the instrument would allow marketplaces to sell more detailed information including broker numbers to interested parties, we believe that broker numbers are an important source of information that should be provided across the markets through the data consolidation process to ensure accuracy and accessibility.

Furthermore, the prescribed information would require data vendors to develop a new data feed in addition to the one currently used. There should be an analysis of the costs involved in using a third-party data consolidator, including the costs involved in the duplication of information from the current reporting systems. While we believe in access to information for all market participants, we do not think that the CSA should be mandating the prescribed information so as to prevent marketplaces from entering into

arrangements with the data consolidator to distribute additional information.

### **3. Trading Rules**

The Notice states that the rationale behind the Trading Rules is that ATSS should not be subject to rules set out by other, competitive, market participants. As such, the CSA proposes to establish basic trading rules that will apply across all marketplaces. While we recognize the importance of having a common framework of principals for the Canadian market, we believe that the proposed Trading Rules go too far. Little justification is provided for the new rules, some of which would have a significant negative impact on the entire marketplace and pose a significant burden for existing participants. As stated in the background paper to the proposal, the regulator should not try to define the perfect market structure but rather should allow healthy competition among participants to foster innovative developments that will benefit investors. Our specific comments and concerns with respect to the Trading Rules are set out below.

#### **a) Capping and Pegging**

We do not support the proposed capping and pegging rules as they are too restrictive. We acknowledge that manipulative trading activity, which is designed to ensure that an option expires out of the money, should not be allowed. However, we believe that such activity should be captured by the general Price Manipulation rule, which should be amended accordingly.

A blanket restriction against capping and pegging would prevent a person or company that has sold both a put option and a call option in the same class of securities from hedging positions in this security. This would likely cause dealers in the institutional derivative market to withdraw from that market and effectively terminate the Canadian options market, thus driving liquidity to competing markets in the US.

#### **b) Short Selling**

We also believe that the proposed short selling rule is too restrictive. The “zero-minus tick” rule currently being used by the Toronto, Montreal and Alberta Stock Exchanges maintains market stability, attracts business and creates liquidity. We are not aware of any negative impact such as price manipulation resulting from the use of this rule. The proposed “zero-plus tick” rule is only in place at the Vancouver Stock Exchange. No justification has been given for adopting this more restrictive rule. We believe that the less restrictive and more widely used “zero-minus tick” rule should be maintained in order to promote

liquidity in the equity and derivative markets. In addition, the current TSE exemptions to the short selling rule should be recognized and included in the proposed rule.

**c) Principal Trading and Offsetting Orders**

The rationale behind the principal trading and offsetting orders rule is to create standards for achieving best execution for customer orders and for ensuring that fair and ethical standard are applied across all markets. The offsetting orders rule is intended to reward participants who display their orders publicly. However, the proposed changes do not ensure the existence or establishment of a Central Limit Order Book. This is illustrated by the US experience where the cross interference rule at the New York Stock Exchange has sent liquidity to regional exchanges which has resulted in market fragmentation. Similarly, a prohibition on crossing and customer client transactions in the Canadian exchanges will likely send the institutional block market to the US regional exchanges, where quote matching is permitted with respect to competing markets.

The Canadian institutional block market plays a unique and important role in the overall Canadian market system. Negotiating large blocks of stock often requires a significant investment of time and work by traders as there are a limited number of buyers and sellers able to absorb these quantities of securities. The offsetting orders rule could enable individuals to misuse information in order to disadvantage a trade. Any individual or broker who obtained information about an upcoming trade could offer up any amount of stock and thereby participate in the trade. As a result, dealers would be less likely to utilize capital for such trades, as their margins for error would increase. As well, the requirement that exchanges and ATSS ensure that orders in other markets are filled before crosses are executed in their own markets will impose significant transaction costs and burdens across the market. We believe that the costs associated with the offsetting orders rule would not outweighed by any beneficial effect on the price discovery mechanism in the market. In fact, the offsetting orders rule would in all likelihood reduce liquidity and lead to market fragmentation.

The principal trading rules introduce a higher threshold than is currently in place at the TSE. No justification is put forward for this increase. We believe it will result in more institutional orders being caught by the rule. However, the TSE Special Committee Report on Market Fragmentation tried to avoid regulating the institutional market in this respect. We believe that the thresholds established by the TSE should remain

in place.

## **Conclusion**

The introduction of ATs into the Canadian marketplace will present unique opportunities to increase competition and achieve further integration of the market, thus benefiting Canadian investors in the long run. However, we also believe that the first priority for the CSA should be strengthening the Canadian market in order to ensure our competitiveness in a global marketplace. As a result, we believe that the establishment and maintenance of a Central Limit Order book is imperative if we are to maintain a central Canadian capital market. In addition, we believe the current realignment of the existing Canadian exchanges should be completed before the CSA finalizes the framework for new competition from within in the form of ATs. Once we have strengthened the Canadian capital market and completed the realignment of the exchanges, the time will then come to integrate ATs into our markets with appropriate safeguards to ensure decreased, rather than increased fragmentation.

We believe that the Alternative Trading System Proposal has many positive aspects and look forward to the opportunity to comment on it again in the future. We would also be pleased to discuss our concerns with you should you wish to do so. If you have any questions or wish to discuss our comments, please do not hesitate to contact any of the following:

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We appreciate this opportunity to respond to the Alternative Trading System Proposal.

Yours truly,

Cindy Lewis  
President, Institutional Equity Traders Association

on behalf of the membership of:  
Institutional Equity Traders Association  
Montreal Institutional Equity Traders Association Inc.  
Vancouver Security Traders Association