



September 20, 2000

John Stevenson
Secretary
Ontario Securities Commission
20 Queen Street West
Suite 800, Box 55
Toronto, Ontario M5H 3S8

Dear Mr. Stevenson:

Re: CSA Transparency Proposals for Debt Markets

Members of the IDA Capital Markets Committee and Primary Dealer Money Market Committee (the "Committees") have carefully reviewed the revised draft of the CSA Proposal for Alternative Trading Systems released July 29, 2000. The observations and recommendations in this letter reflect the views and carry the support of IDA member firm representatives on these Committees. The Committees commend the efforts of the CSA to impose regulatory reform in debt and equity markets to promote improved investor choice, and more liquid and efficient capital markets. We believe the decision to segment the debt and equity markets for the purposes of imposing regulatory reform will result in more effective policy and greater likelihood that the end objectives will be achieved.

The structure of debt and equity markets in Canada are fundamentally different. The equity markets are auction markets in which posted prices represent investor prices to buy and sell securities whereas debt markets are principal markets where prices reflect dealer offers to buy and sell securities; client limit orders exist in equity markets whereas no similar concept occurs in debt markets; retail and institutional investors participate actively in equity markets whereas debt markets are predominantly institutional markets; displayed equity prices are a uniform representation of underlying market supply and demand conditions whereas displayed debt prices incorporate mark-ups to reflect dealer commission and settlement costs. These fundamental differences demand different trading rules and organizational framework. They also have profoundly different implications for market transparency.

The Committees note that enhanced transparency is the principal objective of the CSA proposals for debt markets. The Committees agree with CSA staff that effective transparency of the over-the-counter debt markets is a necessary condition to promote liquid and efficient markets. In this regard, IDA member firms have been, and continue to be, committed to improving the transparency of debt markets through participation in the CanPX project. These member firms have worked assiduously for over ten years to make CanPX transparency a reality. Through this period IDA member firms have overcome serious legal and regulatory obstacles related to Cantor Fitzgerald participation in the CanPX system, and have invested much effort in creating a corporate framework acceptable to the inter-dealer broker participants. The direct costs of the CanPX project have totalled more than one-half million dollars in this period, an amount which

more than doubles if the time committed by industry executives is included. The owners of CanPX have never anticipated the CanPX project would earn sufficient economic return to justify the investment outlay, reflecting the public interest objective of promoting visible debt markets. A rudimentary version of CanPX has been operating free-of-charge for debt market participants for about one year and we expect the final CanPX system to be operational by year-end.

The Committees believe the CanPX model represents the optimal transparency approach for debt markets. Market information on actively traded benchmark and “off-the-run” government securities from the liquid wholesale market provides an unambiguous reference or benchmark for institutional and retail investors to assess security value in the marketplace. This information is supplemented by indicative price information on actively traded bond and money market securities available through an expanding array of internet websites and information service providers.

Based on the provisions in the Proposal, CSA staff apparently disagree with the approach to optimal transparency taken by the Committees. The CSA Proposal infers that the CanPX model is not sufficient to promote an acceptable transparency standard for debt markets and proposes broadening the sources of market information for display by including price and volume information from market-makers and other marketplaces (presumably alternative trading systems). The specific questions raised in the CSA Proposal in respect of debt markets relate primarily to the extent of information that should be drawn from these markets and how quickly data aggregation should proceed.

In reformulating the conventional transparency paradigm by moving beyond the wholesale marketplace to embrace other dealing and trading operations, CSA staff have failed to take fully into account certain characteristics of debt markets that impinge on the CSA Proposal -- notably that dealing prices on many debt securities are made “on demand” and not part of a continuous and regular market-making process; that prices vary significantly by individual transaction size; that prices are often discontinuous reflecting changing market conditions; and that debt prices signal underlying inventory positions in dealing books. Any initiative displaying detailed information from dealing books will confuse investors, reduce dealer willingness to make bid-offered prices, create an incentive to move trading operations offshore and increase transaction costs. As a result, transparency efforts will not be advanced, market liquidity will be damaged, borrowing costs will increase and significant costs will be borne by the industry and investors.

1. Inclusion of dealer transaction information will result in less transparency

The underlying premise in the CSA Proposal is that dealer transactions with clients reflect market-making activity. For most benchmark government securities and selective “off-the-run” securities, dealers act as market-makers, making continuous two-way markets to buy and sell these securities. However, for many government securities, particularly securities issued by the smaller provinces, municipalities and crown corporations, and virtually all corporate securities, including investment grade bonds, dealers quote selectively on demand from clients. Available statistics indicate that the corporate market is for the most part a

thinly traded marketplace.¹ For these securities, and for many federal and provincial securities, dealing activity would in fact fall outside the CSA definition of “market-maker”² and pre-trade and post-trade information would not be provided to the information processor. If this information were nonetheless mandated under the Proposal, it would not be helpful to investors because most pre-trade prices would not be immediately executed and also that intermittent dealing activity in these securities would result in a discontinuous pattern of pricing as market conditions change.

Second, pre-trade and post-trade prices on debt securities are dependent on transaction size, reflecting the inclusion of dealer mark-ups and settlement costs. As a result, at any point in time, prices on similar debt securities can vary significantly, not because of more competitive dealing, but because of differences in transaction size. Lowest price would therefore not necessarily mean best price. This information would be confusing to investors.

2. Exposure of dealer transaction information will erode market liquidity

The CSA Proposal contemplates that market-makers would provide pre-trade and post-trade information to the information processor for eventual display. Since quoted bid and offered prices frequently relate to underlying inventory positions of the dealer, display of this information would expose dealing positions and make market-makers reluctant to quote prices on a continuous basis, in this way damaging the price discovery process and market liquidity. The exposure risks would be more pronounced in less liquid markets, such as the provincial and corporate markets, suggesting that mandated display of market data on corporate securities would have serious repercussions for liquidity. Further, the display of this dealing information could signal the trading intentions of institutional investors that could discourage their participation in secondary markets. Reduced trading activity by dealers and investors will widen bid-offered spreads and raise borrowing costs. A “market-inclusive” approach to transparency will also encourage trading activities to shift to offshore locations, seriously eroding domestic liquidity.

3. Dealer transaction information will increase dealing costs

The CanPX project has cost the IDA member firms and participating inter-dealer brokers more than \$500,000 since its inception in the early 1990s. Requirements to expand the CanPX system to incorporate market information from dealing desks and alternative trading systems will require expanded infrastructure and related expenditure. Moreover, this

¹ Traded volume in the corporate bond market totalled \$71 billion last year or \$283 million average volume per day. Given 25-50 actively traded corporate issues in the market, daily trade for each issue averaged \$6-11 million (purchases and sales each count in the volume figures). Based on average transaction size of \$2-5 million, these data suggest few trades occur, on average, for individual issues in the corporate market. The provincial market is similarly thinly traded. Annual traded volume totalled \$334 billion last year or \$1.3 billion per day. Individual issues trade intermittently in this market, given 12 actively traded issues and average trade size of \$5-10 million. In contrast, the Canada bond market is much more actively traded. Annual traded volume in the Government of Canada bond market totalled \$3.4 trillion last year. Average daily volume for individual Canada issues totalled \$14 billion, based on 15 actively traded issues with average transaction size of \$15-25 million. This Canada bond turnover is nearly 50 times greater than average turnover for individual corporate issues.

² “Market-maker” means any dealer that holds itself out as being willing to buy and sell a security for its own account on a regular or continuous basis.



additional information has limited economic value since data on government securities drawn from dealing desks will essentially duplicate data already provided from the wholesale market through CanPX. The significant infrastructure costs of a modified CanPX system will not be recouped from the sale of this additional information, causing the costs to be absorbed by dealers or passed through to investors.

It should not be construed that objections of the Committees to the CSA approach to debt market transparency suggests transparency cannot be enhanced beyond the existing CanPX standard. As an industry, we are committed to effective transparency and recognize that transparency, as a natural adjunct of the marketplace, is an evolving project. However, the Committees are aware that advancing the transparency agenda can result in significant trade-offs in terms of market liquidity and transaction costs. For this reason, the Committees believe the optimal policy approach is to finalize the planned CanPX project displaying comprehensive information on the wholesale debt markets. The final CanPX system will be operational by year-end. Further modifications to CanPX transparency should proceed on an incremental basis, with initiatives vetted by a committee of experts to avoid negative externalities on the markets. The Committees have formed a transparency working group comprised of senior executives responsible for the fixed income operations of IDA member firms. This group is prepared to meet with CSA staff at the earliest opportunity to discuss in more detail our concerns with the CSA Proposal and develop an effective transparency agenda for fixed income markets in Canada.

Yours sincerely,

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