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BY EMAIL

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Ms. Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Dear Ms. Morris:

Re: Notice of National Association of Securities Dealers, Inc. Filing of Proposed Rule Change Relating to Amendments to Rule 2320(g) and Corresponding Recordkeeping Requirements Under Rule 3110(b) [Release No. 34-54650; File No. SR-NASD-2004-130]

TSX Group Inc. ("TSX Group") appreciates this opportunity to comment on the above-referenced proposed rule change filed by the National Association of Securities Dealers, Inc. ("NASD") with the Securities and Exchange Commission (the "Commission" or "SEC"). The proposed rule change would amend NASD Rule 2320(g) (the "Three Quote Rule") to exclude transactions in foreign securities of a foreign issuer that are included in the FTSE All-World Index and would provide a corresponding exclusion from the recordkeeping requirements in NASD Rule 3110(b) relating to the Three Quote Rule. According to the filing, if the proposal is approved, the NASD plans to withdraw all existing exemptions it has granted to the Three Quote Rule that relate to transactions in foreign securities, including exemptions for customer transactions in Canadian securities executed on a Canadian exchange on an agency or riskless principal basis.[1]

We support efforts by the NASD to revise the Three Quote Rule so that it does not hinder best execution. However, we believe that withdrawing the existing exemptions for Canadian securities is unwarranted and will likely make it more difficult for firms to obtain best execution for the vast majority of securities that are listed on Canadian exchanges[2] and, under the existing exemptions, are currently not subject to the Three Quote Rule. As discussed below, we urge that the NASD either retain the existing exemptions from the Three Quote Rule for customer transactions in Canadian securities executed on a Canadian exchange or alternatively expand the proposed exemption to cover customer transactions in any foreign security executed on the exchange that is the primary trading market for the security.

I. Overview of TSX Group and the Canadian Exchange Markets

TSX Group provides an efficient, liquid and transparent market for a broad cross-section of Canadian issuers. It operates Canada's two largest national equities exchanges:

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1 See SEC Release No. 34-54650 n.13 (Oct. 15, 2006), 71 Fed. Reg. 63812 at 63813 n. 13 (Oct. 31, 2006).

2 Only a small number of issuers listed on Canadian exchanges (approximately 60) are included in the FTSE All-World Index.

Toronto Stock Exchange ("TSX") and TSX Venture Exchange ("TSXV"), which serves the public venture capital market. TSX and TSXV are currently home to more than 1,500 and 2,200 issuers, respectively. Both TSX and TSXV operate fast, efficient, liquid and transparent marketplaces with an electronic central limit order book. TSX and TSXV are global leaders in reliability and speed, providing a transparent auction, full price protection and price/time priority. Issuers listing on TSX and TSXV are subject to listing requirements designed to ensure the liquidity of listings. Firms trading on TSX and TSXV are also subject to extensive regulation, including best execution obligations.

Established in 1861, TSX became the first fully electronic market in North America in 1977. For the first 10 months of 2006, TSX had an average daily trading volume of approximately 320 million shares. TSX market makers are required to contribute to market liquidity and depth and must provide market continuity within a pre-specified range. TSX Market makers are also generally required to fulfill order-flow needs through guaranteed minimums whenever orders in the central limit order book do not meet the size required to fill orders at the quote. TSX continuously monitors the performance of all TSX market makers to ensure that they contribute to the overall market in terms of creating liquidity, depth and continuity.

II. Background

The Three Quote Rule generally requires that members holding customer orders in securities not listed on a U.S. exchange contact a minimum of three dealers (or all dealers if there are three or fewer dealers) and obtain quotations, if there are fewer than two quotations displayed on an inter-dealer quotation system that permits quotation updates on a real-time basis. However, since at least 1998, the NASD has provided exemptions from the Three Quote Rule for customer transactions in Canadian securities executed on a Canadian exchange. Under the terms of the exemptions, customer transactions in Canadian securities executed on a Canadian exchange are exempt from the Three Quote Rule, provided the member monitors for best execution and handles the transactions on an agency or riskless principal basis. The NASD granted the exemptions on the basis of representations that executions on a Canadian exchange at the exchange price ordinarily result in customers obtaining best execution for their orders.[3]

The NASD is now proposing to amend the Three Quote Rule to exclude transactions in foreign securities of foreign issuers that are included in the FTSE All-World Index. The NASD states that it believes that the criteria used in determining the composition of the FTSE All-World Index helps to ensure that the securities trade with a high degree of liquidity, consistency and price transparency. In addition, the NASD states that it has selected the FTSE All-World Index in part because the SEC staff recognizes a subset of the securities listed on the FTSE All-World Index as having a "ready market" for net capital purposes and the Board of Governors of the Federal Reserve System recognizes the FTSE All-World Index in determining whether stocks are eligible for margin treatment. If the proposed rule change is approved, the NASD states that it will withdraw all existing exemptions from the Three Quote Rule.

III. Transactions Executed on TSX and TSXV Should Continue to be Exempt from the Application of the Three Quote Rule

We are not aware of, and in its proposal the NASD does not identify, any problems presented by the existing exemptions (now in effect for longer than eight years) from

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[3] See NASD Notice to Members 00-84 (Dec. 2000).

the Three Quote Rule for customer transactions in Canadian securities executed on a Canadian exchange. Indeed, the NASD does not provide any rationale for its intention to withdraw the exemptions. As they did when the exemptions were granted, executions on TSX and TSXV continue to provide customers with best execution for their orders. Contacting, and obtaining quotes from, three dealers for TSX and TSXV listings would likely cause significant delays in executions. In many instances, a dealer market for TSX and TSXV listings may not even exist. Requiring firms to obtain quotations away from the primary market would impose a number of practical problems and, as the Commission has previously recognized, may hinder a firm from obtaining best execution for its customer.[4]

Only a very small number of securities listed on Canadian exchanges are part of the FTSE All-World Index. Accordingly, if the NASD withdraws the existing exemptions from the Three Quote Rule for Canadian securities, transactions in thousands of securities listed on TSX and TSXV would become subject to the Three Quote Rule. Eliminating the existing exemptions from the Three Quote Rule for TSX and TSXV listings would, as a result, significantly interfere with the existing flow of orders from the United States to TSX and TSXV without any corresponding benefit to customers. Because in most, if not all, instances TSX and TSXV provide the best markets for their listings, requiring firms to obtain quotes that are likely to be away from the inside market would cause unnecessary delays in execution and might well impede a firm from obtaining best execution for its customer. Certainly, there is no statistical evidence that the quality of executions in Canadian securities would be improved by operation of the three-quote process rather than by routing to the exchange that is the primary trading market for such securities. Accordingly, we urge that the NASD maintain its current exemptions for customer transactions executed on Canadian exchanges, absent statistical evidence that withdrawing the exemptions would lead to improvement in the quality of executions in Canadian securities.

Alternatively, we recommend that the NASD expand the proposed exemption to cover transactions in foreign securities executed on the primary market for those securities. As a general matter, for best execution purposes, we believe that it is highly unlikely that the dealer market for a foreign security would be more active and offer better prices than the primary market on which the security is traded.[5] That is certainly the case with respect to TSX and TSXV. If the NASD has market-specific concerns, it might consider limiting the exemption to securities listed on exchanges in countries whose securities are included in the FTSE All-World Index.

In proposing to exempt securities included in the FTSE All-World Index, the NASD states that it believes the criteria used in determining the composition of the index helps to provide a high degree of liquidity, consistency and price transparency. However, the NASD does not address the fact that for securities listed on a foreign exchange, a liquid interdealer market may not exist, and, even where it does exist, would likely not have prices superior to those on the primary exchange market. The assumption that exchange prices are generally superior underlies the fundamental distinction made in the Three Quote Rule between U.S.

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[4] See Securities Exchange Act Release No. 39266 (Oct. 22, 1997), 62 Fed. Reg. 56217 (Oct. 29, 1997) and Securities Exchange Act Release No. 34-38935 (Aug. 14, 1997), 62 Fed. Reg. 44501 (Aug. 21, 1997).

[5] We see no reason to suspect that an exchange that is the primary trading market for a security would offer less protection than an interdealer quotation system showing only two quotations (an alternate basis for exception from the three-quote process).

exchange-listed securities (to which the rule does not apply) and the over-the-counter markets (to which the rule generally does apply).

The NASD relies in part on the fact that the FTSE All-World Index is used for net capital "ready market" purposes and for margin eligibility. Determining which securities have a "ready market" for net capital purposes or establishing which securities are eligible for margin treatment presents a different inquiry that that involved in determining whether customers would, on balance, be advantaged or disadvantaged by preventing the automated routing of their orders to a foreign exchange, particularly in the case of a foreign exchange that is the primary trading market for the relevant security. Moreover, the FTSE All-World Index incorporates numerous criteria that would limit the inclusion of individual securities (such as the relative capitalization of the issuer, the relative size of the market in the country in which the issuer is listed, etc.) that have nothing to do with the determination whether investors would achieve better executions on the listing foreign exchange than in the over-the-counter market.

We understand and support the desire of the NASD to establish an objective standard that would obviate the need for a resource-intensive approach involving numerous ad-hoc determinations. However, we do not believe that the current proposal effectively balances the desirability of an objective standard and the execution needs of investors in foreign securities. Indeed, we respectfully submit that the current proposal would, by interjecting delay and inefficiency in order routing, adversely affect the quality of execution for the vast majority of transactions in Canadian and likely other non-U.S. securities.

IV. Conclusion

We believe that withdrawing the existing exemptions from the Three Quote Rule for Canadian securities would interfere with the existing flow of orders from the United States to TSX and TSXV without any corresponding benefit to customers. Indeed, in many instances, applying the Three Quote Rule to transactions in securities listed on TSX and TSXV would likely hinder best execution. Accordingly, we request that the NASD retain the existing exemptions for Canadian securities or, alternatively, expand the proposed exemption from the Three Quote Rule to cover customer transactions in any foreign security executed on the exchange that is the primary market for the security—at least in the case of exchanges located in jurisdictions whose securities are included in the FTSE All-World Index.

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TSX Group thanks the Commission for the opportunity to comment on the NASD proposal to amend the Three Quote Rule. If the Commission or its staff has any questions or would like further information regarding our comments, please feel free to contact me at 416-947-4660 or via e-mail at rik.parkhill@tsx.com or our counsel Edward J. Rosen or Ardith Eymann at Cleary Gottlieb Steen & Hamilton LLP.

Sincerely,

Rik Parkhill

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cc. Eric R. Sirri, Director, Division of Market Regulation, SEC
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