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BANK OF CANADA **Publications & Research**

Comments on Proposed revisions to the rules pertaining to auctions of Government of Canada securities and the Bank of Canada's surveillance of the auction process (Discussion Paper 1)

Commentaires sur le Projet de modification des règles régissant les adjudications de titres du gouvernement canadien et la surveillance de celles-ci par la Banque du Canada (Premier document de travail)

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Investment Dealers Association of Canada (Capital Markets Committee and Bank of Canada Jobbers Committee)

**Submission
on
Bank of Canada/Department of Finance**

Discussion Paper on Auction Reform

Executive Summary

The Bank of Canada and Department of Finance released a discussion paper on 19 December 1996 entitled "Proposed revisions to the rules pertaining to auctions of Government of Canada securities and the Bank of Canada's surveillance of the auction process" and requested comments from interested parties by 31 March 1997. The IDA Capital Markets Committee and Bank of Canada Jobber Committee have prepared a submission which comments on the issues raised in the discussion paper and makes policy recommendations to improve the integrity of the Bank of Canada auction and the secondary markets for Government of Canada securities. The Committees concur with the Bank of Canada and Department of Finance that confidence in the integrity of Government of Canada securities markets to promote liquid and efficient markets should be a priority policy objective. The Committees also recognize that developing structural problems in domestic debt markets, reflecting the growing imbalance between demand and supply, will contribute to thinning liquidity in traded issues and increase the vulnerability of markets to manipulation in both the auction and secondary markets.

Representatives of the Capital Markets Committee and Bank of Canada Jobber Committee met frequently over the past three months to review the federal proposals and consider whether these proposals are adequate to ensure the integrity of the auction process, and also to recommend additional proposals to strengthen the integrity of markets. The Committees take issue with the objective of the reform proposals which are described as an effort to eliminate auction squeezes and corners. Bonds and treasury bills in relatively tight supply and therefore available "on special" in repo markets are a relatively common occurrence in international sovereign debt markets and are not necessarily confidence-damaging circumstances. The Bank of Canada must distinguish between those circumstances where Government of Canada securities are subject to a squeeze, but can be borrowed at a premium in repo markets, and circumstances where securities are only available at exorbitant rates or not at all.

The submission makes several recommendations related to Jobbers and Primary Distributors participation at auction and in secondary markets, and proposed customer bidding practices. These recommendations represent the consensus of the Capital Markets Committee and Bank of Canada Jobber Committee and, accordingly, should carry significant weight in subsequent discussions with Bank of Canada and Finance officials.

Related Party Rules

The related party rules in the discussion paper have a critical influence on the maximum bidding limits for Primary Distributors. The maximum bid must be reduced for holdings which exceed 20% of the outstanding bonds. The holdings of all related affiliates of the Primary Distributor would be aggregated for the purpose of determining the maximum bid. Since nearly all affiliates of Primary Distributors are related (with the exception of the investment management arms), based on the Bank of Canada definition which turns on "the exchange of information in the auctioned securities", the aggregate holdings of benchmark securities could be sufficiently large to prevent the Jobber and Primary Distributor from bidding at auction. The problem could be alleviated with possible modification to the related party definition (consistent with the overriding policy

objective), or removal of the proposed rule itself -- or if the Jobbers and Primary Distributors are prepared to reorganize their fixed income infrastructure by operating units independently rather than as part of an integrated group.

The Committees recommend that the Bank of Canada proceed with the planned reporting of affiliate positions in auctioned securities on an interim basis to verify the impact of these holdings on the auction process and determine whether large securities positions translate into excessive squeezes and market dislocations.

Primary Distributor Bids at Auction

The Committees believe that the integrity of the auction process for Government of Canada securities, and trading in secondary markets, can be improved by imposing specific rules on Jobbers and Primary Distributors mandating fair and proper trading practices. These Jobbers and Primary Distributors are key participants in the auction and in the aftermarkets.

The Committees recommend consultations with the Bank of Canada to agree on appropriate rules governing Primary Distributor conduct in the auction and in secondary markets. The Committees propose that all Jobbers and Primary Distributors be members of the Investment Dealers Association in order that they are subject to IDA compliance and enforcement procedures. The Committees envision strict penalties for infractions to the rules.

Customer Bids at Auction

The customers of Jobbers and Primary Distributors would be permitted independent bidding limits for Canada treasury bills and bonds to a maximum of 33 1/3% and 20% of auctioned treasury bills and bonds respectively. Bids would be submitted to the Bank of Canada through Jobbers and Primary Distributors and the auctioned securities would be settled directly with the customer through the Canadian Depository for Securities. This proposal would give customers better access to auctioned Canada bonds than the tiered access available to most Jobbers and Primary Distributors.

Although customers can at present bid for an even higher percentage by submitting pre-tender orders through Jobbers and Primary Distributor bids, the independent bidding limits and direct settlement arrangements raise the status and profile of customers at the Bank of Canada auctions. The proposal therefore undermines the only incentive given to Jobbers and Primary Distributors for carrying out their market-making and auction participation responsibilities. Also, the proposal risks Jobbers and Primary Distributors being less pro-active in making markets and in bidding at auction.

The customer bidding limits and direct settlement with the Bank of Canada also creates serious administrative problems for the Bank of Canada. The Bank must be prepared to give Primary Distributors and other market participants full assurance that customers bidding at auction will report existing holdings and bids in a timely and accurate fashion directly to the Bank to ensure the auction is not disrupted. The Bank will also have to engage in credit analysis of customers to avoid transaction failures in auctioned securities.

The Committees are not opposed to the concept of customer bidding limits on the

condition that the maximum bidding limits for customers be set at levels well below the 33 1/3% and 20% treasury bill and bond thresholds contemplated in the proposals. Further, customer bids should be included as part of the Jobber and Primary Distributor bid. This provision means the customer bid would result in a corresponding reduction in the bid of the Jobber and Primary Distributor who acts as the conduit for the customer.

Restructuring of Government of Canada Treasury Bill and Bond Borrowing Programs

The Committees believe that the borrowing programs for Canada treasury bills and bonds will have to be restructured to mitigate the adverse liquidity consequences of collapsing borrowing requirements. The Committees recommend that the Bank of Canada and Department of Finance engage in ongoing consultations with market practitioners to design the most appropriate issuance structure for Government of Canada securities.

INTRODUCTION

The IDA Capital Markets Committee and Bank of Canada Jobber Committee are pleased to provide comments to the Bank of Canada and Department of Finance on the discussion paper "Proposed Revisions to the Rules Pertaining to Auctions of Government of Canada Securities and the Bank of Canada's Surveillance of the Auction Process". The discussion paper was released to Bank of Canada Jobbers and Primary Distributors, and other market participants, in late December last year. The Capital Markets Committee and Bank of Canada Jobber Committee ("the Committees") recognize the concerns which underpin the proposals to reform the auction process and have worked co-operatively to respond constructively to these proposals. The Committees also recognize that the integrity of the auction process and the secondary markets for Government of Canada securities is critical to investor confidence and to the liquidity and efficiency of domestic debt markets.

The Committees established a Task Force in early January to act as a catalyst to identify reaction to the proposals and build an industry consensus in responding to the government discussion paper. The Task Force liaised frequently with representatives from IDA member firms represented on the Jobber Committee and Capital Markets Committee. The response to the discussion paper and recommendations contained herein represent the consensus of all members of the IDA Capital Markets Committee and Bank of Canada Jobber Committee. The membership of these Committees represents large and small investment dealers, with these dealers accounting for more than 95% of the turnover in Government of Canada securities markets. The Bank of Canada and Department of Finance, in preparing a revised version of the discussion paper, should give careful consideration to these comments and recommendations, recognizing they have the full support of the Canadian securities industry.

The Committees understand Bank of Canada/ Department of Finance concerns that frequent squeezes and corners in the markets for Government of Canada securities damage investor confidence and market participation, and can have a debilitating impact on liquidity and efficiency of domestic debt markets. However, the Committees believe that these concerns about squeezes are overstated. The Committees agree that significant structural changes are occurring in domestic markets, which dramatically alter the demand-supply balance for debt securities and exacerbate market liquidity problems. Collapsing federal borrowing requirements will reduce the supply of marketable

securities, notably for short-dated securities, as the maturity of the debt structure is lengthened. At the same time, the dramatic growth of investable funds has increased the appetite for debt securities. For example, the assets of the top forty money managers rose 16% last year to total \$221 billion while the assets of the top twenty mutual funds increased by one-third in the same period to total \$113 billion.

The Committees, however, caution the Bank of Canada and Department of Finance in implementing policy aimed at remedying potential squeezes in Canadian government securities markets. It should be understood that squeezes or Canada bonds "on special", are a relatively common occurrence, even in the most liquid sovereign debt markets. In the past several years, there have been numerous examples of squeezes in particular securities issues in the U.S. Treasury market, and, as well, in the Japanese and German debt markets. There is a significant difference in tight demand-supply conditions for Canada bonds and treasury bills between those securities which are in relatively short supply but can be borrowed at a premium in repo markets, and those securities which are available at exorbitant rates or not at all. It is difficult to believe any policy remedy exists, given developing structural problems in Canadian debt markets, which will be the ultimate panacea to prevent the occurrence of market squeezes in primary and secondary debt markets.

It must also be recognized that large accumulated holdings are not, in and of themselves, detrimental to the marketplace. A distinction must be made between large portfolio holdings in benchmark issues which are on-lent to market participants at fair market prices through repo markets to cover existing short positions in the markets, and locking-in these securities with the intention of disrupting the proper functioning of the markets. In other words, accumulated holdings of particular securities are not necessarily damaging to the liquidity of the markets, as long as these securities are traded back into the market to benefit other market participants. The converse is also true. Market participants can cause squeezes in particular securities issues, even if their portfolio holdings in these securities may not be excessive in relative terms, by simply refusing to lend out these securities to other market participants. Moreover, Jobbers or Primary Distributors could finance a large controlling block of benchmark Canada debt securities by arranging a reverse repo transaction with the client. As a result of this financing, the Jobber or Primary Distributor could wield considerable influence over the marketplace in these benchmark issues without in fact owning any of the securities in question. It should be noted that a customer, as well as a Jobber or Primary Distributor, could undertake a similar financing transaction for another customer through the repo market.

These observations should be kept in mind in designing new procedures for participating at auction and in secondary markets. Rules which unduly restrict the activity of participants at auction, or in secondary markets, to pre-empt potential squeezes which could be damaging to capital markets, could have a more detrimental influence on the markets than the squeezes themselves. The Committees believe that the rules proposed in the discussion paper fall into this category. Any changes to existing practices should be introduced carefully. In this regard, we support the Bank of Canada and Department of Finance approach which relies heavily on the consultative process to initiate structural changes to the auction process.

The policy remedies suggested by the Bank of Canada and Department of Finance would apply only to the auction process. The jurisdiction of the federal government and the Investment Dealers Association does not extend to investors participating in secondary

markets. This regulatory gap leaves markets vulnerable to possible manipulation by rogue investors. However, this circumstance is essentially not unlike that in U.S. markets where Federal Reserve influence and jurisdiction extend in the main to Primary Distributors. The Fed relies primarily on self-regulation among market participants to deal with secondary market squeezes. For example, if an investor accumulates a large position in the particular issue with the intention of squeezing the issue, because many Primary Distributors would be short these auctioned securities, and the ultimate victims of the squeeze, as a group they can put pressure on these investors to conduct their activities more appropriately.

Primary Distributor Bids at Auction and the Related Party Definition

The discussion paper proposes that the maximum bid of the Primary Distributor for auctioned Canada treasury bills and bonds should be adjusted for the net portfolio holdings in these auctioned securities. If these net holdings (defined as the holdings of cash securities and "when issued" securities) exceed 20% of the outstanding bonds, then the maximum bid would be reduced by the corresponding amount. As a result, the Primary Distributor bid could be constrained depending on the relationship between the trading and investment fund operations affiliated with the Jobber and the Primary Distributor. The implications for the Primary Distributor bid at auction, in all market conditions, must be fully understood before the proposed model is implemented so that auction coverage is not put at risk.

The adjustment of the maximum bid at auction, adopted from the U.S. auction rules, is designed to reduce the risk that Jobbers and Primary Distributors with significant holdings of Canada bonds or treasury bills, when combined with auctioned securities, could initiate squeezes and corners in the marketplace. The organizational structure of the corporate group which is affiliated with the Primary Distributor will ultimately determine the frequency and extent that portfolio holdings would influence the maximum bid of the Jobber and Primary Distributor.

The Committees believe that, based on the definition of "related party", each bank-owned dealer group must make an independent judgement on the dealing operations and investment affiliates which are included with the Primary Distributor for the purposes of determining the maximum bid. This judgement turns on whether these affiliate operations are in fact related to one another -- namely, that they exchange information in respect of the securities being auctioned. The Committees have concluded that the repo, swap, proprietary, money market and bond desks of the dealer (or dealer-bank group) operate as an integrated unit and therefore the securities holdings in these operations are included in the Primary Distributor reported totals for the purposes of determining the maximum Primary Distributor bid.

As a result, we believe that Primary Distributors which are part of the bank-owned groups will, from time to time, be constrained in bidding at auction, notably for relatively new benchmark securities which have small amounts outstanding. While the managed funds arm of the Primary Distributor corporate group typically operates on an arms-length basis reflecting its fiduciary responsibilities, and therefore would be defined as a customer or "separate bidder", the same case cannot be made for the internal portfolio of the affiliate chartered bank. In fact there may be communication between the money market and bond desk of the Jobber/Primary Distributor, and the internal portfolio of the bank and, if so, the internal portfolio would be related to the Primary Distributor.

Based on available statistics (Statement of Chartered Bank Assets and Liabilities, Bank of Canada Review, Table C3), these internal chartered bank portfolios are large, representing about 15% of marketable Canada bonds outstanding and 23% of Canada treasury bills. If this portfolio is related to the Primary Distributor because of the bilateral flow of information on auctioned securities, the bank portfolio holdings of the to be auctioned benchmark bonds or treasury bills would be included as part of the Primary Distributor position and possibly interfere with the maximum bid at auction. The size of these internal bank portfolios could seriously affect the bidding performance of one or more of the Primary Distributors at auction. The coverage of auctions could therefore be seriously compromised.

The Committees reached several conclusions in respect of the related party definition. First, based on the Bank of Canada definition of proposed related party -- "the exchange of any information about yields, amounts, positions they hold or plan to hold, or their investment strategies with respect to the securities being auctioned" -- all internal dealing and investment operations within the corporate bank and non-bank groups would be deemed related to one another, with the possible exception (at least for some corporate groups) of the managed funds affiliate.

The significant portfolio holdings in benchmark Canada treasury bills and bonds within these affiliate operations, particularly the holdings of those entities engaged in swap-related transactions and proprietary trading, and securities held for collateral or investment purposes, would therefore be included as part of the Jobber and Primary Distributor positions for bidding at the Government of Canada securities auctions. These aggregate group holdings could seriously interfere with the maximum bid of one or more Jobbers and Primary Distributors at auction, particularly in the initial rounds of auction reopenings in benchmark securities. The coverage of the Canada treasury bill and bond auctions would be seriously compromised. The rules cause more problems for the auction process than they solve.

Given these circumstances, the bank groups would be forced to operate several business units independently rather than as part of an integrated operating structure to accommodate the proposed rules, and bid consistently at Canada bond and treasury bill auctions. If these organizational changes fail to materialize and the related party definition remains in place, the Bank of Canada runs the risk that the auction process could be disrupted from time to time.

The Committees conclude that the related party definition is overly restrictive, given the intended policy objective. The Bank of Canada and Finance should consider whether a modified related party definition could improve the integrity of the auction process and, at the same time, not disrupt the issuance process for Government of Canada securities. For example, an affiliate could be deemed arms-length, and therefore excluded from the Jobber and Primary Distributor bid, if (i) it carries out a minimal level of market trading, (ii) adopts the practice of soliciting independent bid and offered prices before initiating a trade at the best price or (iii) formally undertakes not to intentionally act together with another affiliate in formulating bids at auction. Written internal procedures, subject to review by the Bank of Canada, would be established to demonstrate effective arms-length relationship with the affiliate firm.

The proposed auction rules which define the maximum bid determined from existing holdings of auctioned securities, and related reporting requirements, presume that

Jobbers and Primary Distributors would manipulate the markets for these auctioned securities. The Committees believe that the Bank of Canada should have reasonable expectations that such a result would occur before imposing costly and complicated reporting obligations on Primary Distributors and their customers, and risking inefficient and possibly unsuccessful auctions of Government of Canada securities. Moreover, the Bank of Canada and Finance should consider whether market manipulation is likely if Jobbers or Primary Distributors were subject to specific rules prohibiting market manipulation in government debt markets.

The Committees recommend that the Bank of Canada and Department of Finance proceed on an interim basis (with filing of the "Primary Distributor Report of Firm-Wide Net Long or Short Positions Entering into Tender") to judge the impact that the aggregate group holdings of related affiliates exert on the Primary Distributor maximum bid. The Bank of Canada should at the same time monitor the auction process carefully and determine whether large related party positions in auctioned securities translate into excessive squeezes at the Bank of Canada auction.

The Committees believe that the most effective approach to guard against excessive squeezes and market manipulation at auction is to impose specific rules on Jobbers and Primary Distributors, and on customers if they are given independent bidding limits and settle directly with the Bank of Canada, to prohibit any market manipulation in Canada debt securities. Further, the IDA rules and related compliance/enforcement procedures could be extended to the secondary debt markets as long as all Jobbers and Primary Distributors are member firms of the Investment Dealers Association (IDA). At present, nearly all Jobbers and Primary Distributors are in fact members of the IDA, with the exception of six firms (four of which already have IDA affiliate firms). The Committees recommend that the Bank of Canada require that all designated Jobbers and Primary Distributors be members of the IDA in order to impose IDA rules, and existing compliance/enforcement procedures, on all Primary Distributors operating in the domestic marketplace. This obligation for IDA membership would not be unduly onerous on existing Primary Distributors given that most Distributors are already members of the IDA; moreover, the move would be justified in terms of the benefits from effectively regulated secondary markets for Government of Canada securities.

Investment firms which are members of one of the four Canadian stock exchanges are already subject to various rules prohibiting such practices as the purchase, sale or offering to purchase or sell equity securities where the effect of such a purchase or sale would unduly disturb the normal position of the market, or create abnormal market conditions. These rules which relate to manipulative and deceptive trading practices could be extended to IDA member firms involved in trading debt securities. If market dislocations arise as a consequence of these prohibited trading practices, then, depending on whether the infraction occurs in primary or secondary markets, the Bank of Canada and/or the IDA can quickly identify the Primary Distributor involved, launch an investigation and mete out appropriate punishment.

The Committees are prepared to work co-operatively with the Bank of Canada to craft detailed rules governing conduct at the auctions for Government of Canada securities and in secondary markets to ensure the integrity of domestic debt markets is preserved. The Committees emphasize that rules are meaningless unless they can be properly enforced. Once the Bank of Canada and the IDA decide on the rules for appropriate conduct at auction and in secondary markets, the Bank should take responsibility for the

enforcement of rules at auction, and the IDA for the compliance/enforcement of rules in secondary markets.

The Committees recommend that the penalties for infractions to the rules be severe and imposed in a fair manner. The penalties should correspond to the seriousness of the infraction. The penalties could range from private and public censure, fines and sanctions on individuals and firms, temporary suspension of bidding privileges, removal of Primary Distributor designation and expulsion from the securities industry.

Customer Bids at Auction

The discussion paper proposes that the customers of Jobbers and Primary Distributors be given independent maximum bidding limits totalling 20% of the auctioned amount of Canada bonds and 33 1/3% of Canada treasury bills. These customers would be required to place these bids through a Jobber or Primary Distributor and then settle the auctioned securities directly with the Bank of Canada through an account at the Canadian Depository for Securities. While the proposal is somewhat analogous to the existing structure which enables customers to submit pre-tender orders through the Primary Distributor bid, the explicit customer account enables the Bank of Canada to monitor the overall size of customer participation at auction (which in the current system could be diffused through several Primary Distributor bids), and the underlying cash and "when issued" holdings of the customer.

The proposal to assign independent bidding limits to customers and direct settlement arrangements undermines the incentive or benefit given to Jobbers and Primary Distributors to make markets and participate consistently at the auction, by raising the status of the customers of Jobbers and Primary Distributors at auction (even though the orders are placed through a Jobber or Primary Distributor), with the defined bidding limits equal to the highest limit accorded to Jobbers and Primary Distributors. The model would in fact put these customers on a better footing than most Primary Distributors -- without having responsibility for market-making and auction participation. Under the proposed scheme, large investors would be given access to 20% of the auctioned Canada bonds, more generous than the tiered access provided to most Primary Distributors. This approach runs the serious risk that Jobbers and Primary Distributors will become less pro-active in market making and bidding at auction, particularly in poor market conditions.

The proposal for independent customer bidding also has the serious disadvantage of drawing information out of the marketplace itself, and in particular away from market makers, thereby damaging the liquidity of the "when issued" markets and cash markets -- notably in the period leading up to the auction. When clients purchase newly offered securities at auction as part of the Jobber or Primary Distributor bid, or in the "when issued" markets, this promotes the bilateral flow of information benefitting the Primary Distributor in building an order book and thereby allowing a better understanding of market flows to position in advance of the auction, and ultimately to bid more effectively on behalf of clients. In turn, the customer benefits from the process by purchasing newly offered securities on more attractive terms than otherwise.

If the customer has his own bidding limit, as contemplated under the proposal, and bids independent of the Primary Distributor, there is greater incentive for the customer to submit pre-tender bids at auction, and mask these bids from the Primary Distributor, of

the intended bid. Primary Distributors and customers will be more reluctant to exchange market intelligence in these circumstances.

The proposed direct client bid and reporting mechanism will also cause serious administrative problems for the Bank of Canada. First, the Bank must initiate procedures to ensure that all domestic and foreign clients bidding for securities report positions in cash and "when issued" securities in an accurate and timely manner, i.e. just prior to submitting a bid at auction, and provide assurance to Jobbers and Primary Distributors that these standards can be achieved. If such reporting is in fact delayed or inaccurate, the securities positions won at auction may be improper and disqualified after the fact, creating serious complications for auction participants in attempting to unwind the auction results. Such episodes could adversely influence the confidence of market participants. Moreover, the proposals envision that the customer will settle his position directly with the Bank of Canada through the Canadian Depository for Securities. The Bank will have to impose safeguards to ensure that these transactions in auctioned securities are properly consummated to avoid failed transactions. This is a responsibility currently borne by the Jobber and Primary Distributor. In this regard, the Bank may have to undertake due diligence of the creditworthiness of all domestic and foreign customers of Jobbers and Primary Distributors interested in setting up accounts with the Bank of Canada for bidding at auction. The discussion paper suggests that the Bank may require that clients establish a line of credit with the settlement agent to guarantee the availability of funds for settlement. However, the Bank may have to go even further and introduce measures to ensure that securities which are bid at auction are in fact properly paid for.

The Committees are not opposed to the concept of customer bidding limits on the condition that the maximum customer bid for Canada treasury bills and bonds be set at a ceiling well below the proposed 33 1/3% and 20% thresholds. Moreover, the Committees recommend that the customer bid be included as part of the Primary Distributor bidding limit. For example, if the customer places a bid for, say, 5% of the auctioned securities through a Jobber or Primary Distributor, the maximum bidding limit of that Jobber or Primary Distributor would be correspondingly reduced by five percentage points. The customer would still be subject to reporting obligations with the Bank of Canada and would settle auctioned securities directly with the Bank.

The recommendation for much lower maximum bidding limits for customers than proposed in the discussion paper would have several positive implications for the marketplace. First, the lower bidding limit for customers will retain a significant incentive for Jobbers and Primary Distributors to carry out their designated responsibilities for auction participation and market-making, but still give customers access to the auction, even though experience demonstrates that currently customers infrequently place pre-tender orders through Jobbers and Primary Distributors. Second, by including the customer bid within the Jobber and Primary Distributor bid, the possibility for collusion between Primary Distributors and their customers would be significantly reduced. For example, under the proposal, Jobbers and Primary Distributors, and their customers, would be permitted to drawdown up to 50% of the auctioned securities (30% for each of the Jobber/Primary Distributor and client) and thereby exert significant control over the market in these securities.

The Committees recognize that the complicated reporting procedures to the Bank of Canada and the restricted maximum bidding limits, may act as a disincentive for customers to place pre-tender bids at auction. However, the Committees believe that this

result would have a positive effect on the marketplace, encouraging those investors interested in significant positions in auctioned benchmark Canada treasury bills or bonds to participate in the "when issued" market. A more active "when issued" market would have a positive impact on the price discovery process for auctioned benchmark securities and on the overall liquidity of the Canada treasury bill and bond markets.

The discussion paper would require that Jobbers and Primary Distributors inform the customer of his reporting obligation with the Bank of Canada (holdings of "when issued" and cash positions in the auctioned securities) when orders, processed through the Jobber or Primary Distributor on behalf of the customer, total \$50 million or more in the auctioned Canada treasury bills or bonds. The customer must report net portfolio holdings in the auctioned securities to the Bank of Canada when aggregate orders total \$100 million. The Committees believe that these reporting obligations, and the notification of the reporting obligations, should rest strictly with the Bank of Canada. The Jobbers and Primary Distributors should not be given the responsibility, nor the contingent liability, of notifying the customer of the Bank of Canada reporting obligation at auction. The Jobber and Primary Distributors should act strictly as a conduit for customers to place orders with the Bank of Canada for auctioned securities.

Restructuring of the Government of Canada Treasury Bill and Bond Borrowing Program

The Committees recommend that the Bank of Canada and Finance initiate consultations with the IDA Capital Markets Committee and Bank of Canada Jobber Committee in respect of restructuring the borrowing program to limit the likelihood of squeezes occurring at auctions for Government of Canada securities.

The collapsing borrowing requirements of the government, in conjunction with a broadly based maturity structure of benchmark issues across the yield curve, adversely impacts market liquidity and increases the opportunities to initiate squeezes in benchmark securities.

We agree with the discussion paper that reform of the auction process, which includes implementing rules and compliance/enforcement procedures related to the business conduct of Jobbers and Primary Distributors, is an important first step in proving the integrity of the marketplace for Government of Canada securities. These reform measures, however, should be undertaken in conjunction with regulatory proposals for the "when issued" markets and secondary markets. Remedial action should also include a restructuring of the Canada treasury bill and Canada bond borrowing programs. The first steps should be to consolidate the benchmark borrowing program by eliminating certain benchmark maturities to ensure the liquidity of existing benchmark issues. While the benchmark Canada three-year bond maturity has been discontinued, further winnowing out of the Canada bond benchmark maturities will be a more difficult process. The Bank of Canada can still maintain large sized offerings for tender at auction by reducing the frequency of the Canada treasury bill and bond auctions. In effect, the Bank of Canada and Finance should reverse the measures taken in the early 1990s to accommodate expanding financing requirements and growing debt. The government should also consider changes in the format of the auctions for Government of Canada securities.

The federal government should rely heavily on consultations with market practitioners in designing a borrowing program compatible with declining financing requirements that

minimizes the likelihood of squeezes at auction. The comments in this submission are restricted to the issues which have been raised in the discussion paper and, accordingly, do not encompass specific proposals to revamp the federal borrowing program. The Committees, however, are prepared to set out their detailed views on this matter in subsequent discussions and written proposals to the Bank of Canada and Department of Finance.

CONCLUSION

In coming years the Government of Canada securities markets will be faced with a growing structural imbalance between the expanding demand for marketable government debt securities and shrinking supply. Managed investment portfolios and mutual funds will continue to expand at a rapid pace over the next several years. Further, even a modest adjustment in portfolio allocation, say, towards increased holdings of debt securities in response to changes in market conditions, will significantly augment portfolio demand for debt securities and exacerbate the demand-supply imbalance.

While some of this growth will come at the expense of the bank deposit base and concomitant shrinkage in bank portfolio holdings of marketable debt securities, there will nonetheless be significant net demand for marketable debt securities. Moreover, the decision to permit the Canada Pension Plan to invest in marketable securities will place further demand pressures on the domestic debt markets.

The eventual decisions which will be taken by the Bank of Canada and Department of Finance to attempt to safeguard the marketplace against squeezes in Government of Canada securities markets, and a restructuring of the federal borrowing program, will probably be ineffective in preventing serious liquidity problems from occurring in those markets. The federal government will ultimately be forced to consider more far-reaching policy decisions -- such as raising the 20% foreign investment limit, and, as well, permitting mutual funds to invest in repo securities as a separate asset class -- to alleviate the structural imbalance in government securities markets by allowing a broader range of investment alternatives.

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Merrill Lynch Canada Inc.

Merrill Lynch Canada Inc.'s Response to Proposed Federal Rules for Reforming Canada Bond and Treasury Bill Auction Procedures

Merrill Lynch Canada welcomes the Government's initiative and consultative process in proposing new rules for reforming Canada Bond and Treasury Bill auctions. We appreciate the opportunity to respond to the Bank of Canada and Department of Finance Paper (the "Paper") directly in addition to our work with the IDA Capital Markets Committee.

In providing this commentary, Merrill Lynch Canada would stress that the auction process for Canada Bonds and Treasury Bills has worked very well in the 1990s. Indeed, we would highlight the liquidity and efficiency of the Canadian government

securities market, especially given its size, as among the best in the world. Yet, the changing supply of and demand for savings in the C\$ fixed income market generally and the reduced Federal financing needs specifically make it timely to review the Canada Bond and Treasury Bill auction procedures. Merrill Lynch Canada believes that a considered analysis of auction procedures will help in generating constructive approaches to future Canada auction bidding limits and the rules governing related parties in the Canadian market.

General Comments

There are three aspects of the Canadian fixed income market that receive extensive or significant comments in the Paper which Merrill Lynch Canada would like to expand upon as a prelude to our specific comments.

1. **Squeezes vs. Special Trading Levels.** The notion of what is a bond being squeezed and a bond that is on special is central to many of the Paper's proposals and merits a brief elaboration. We believe that distinguishing between the two situations is not always straightforward. The trading of bonds on special is the sign of a healthy market and should not be discouraged. As has been demonstrated in 1Q97 with the US 10-year Treasury, selling by accounts of off-the-run bonds together with sales by dealers of the current 10-year Treasury to hedge their off-the-run purchases led to very low repo levels on the benchmark 10-year Treasury for entirely appropriate reasons. We believe that there will be reasonably frequent circumstances in which there will be bellwether Canada bonds temporarily on special - indeed the Paper notes that it is not unusual for bonds to be on special for many reasons unrelated to market manipulation. In this regard, Merrill Lynch Canada would highlight such factors as major changes in interest rate directions, swap desk requirements or major provincial/corporate issuance that result in large-size dealer hedging of inventory.
 - In contrast, squeezes as the Paper highlights are a deliberate attempt to corner bonds to take advantage of a bond issue's scarcity, thereby forcing other dealers to cover their short inventory positions in that security at excessive cost. We would distinguish this market-harming activity from other costly dealer shorts which are self-inflicted expenses. Indeed, what are alleged to be squeezes can be due to inappropriate hedging and/or negative market stances that lead to selling particular bond issue(s) that are in short supply. The latter case is particularly noteworthy for shorter-dated securities. Dealers selling these bonds for non-investor related trading and/or other than for new issue hedging reasons risk significant costs in covering these positions given the shrinking supply of shorter-dated securities from Canada in 1996/97 and beyond.
 - Having noted that not all alleged squeezes are in fact problems, we would reiterate that the risks of genuine squeezes are much greater in shorter-dated bonds. The benefits to holding bonds which are quickly rolling down the yield curve to maturity are very significant in a positively-sloped yield curve where the cost of financing positions generates substantial positive carry and can be expected to do so with a high degree of confidence given the short holding period for exposure to monetary policy changes. Owning 5-year, and especially, 10-year securities over a long period entails much greater

financing cost risk given the increasing difficulty of predicting short-term yield differentials beyond the succeeding 12-18 months.

- Merrill Lynch Canada would advise the Government to move cautiously in designing and implementing rules to deal with squeezes. We believe that there is a serious risk that procedures put in place to minimize or eliminate squeezes if not properly conceived or instituted could reward imprudent behaviour. This could entail major costs for monetary policy if the Government unintentionally provided protection for clients/dealers to sell shorter-dated Canada securities on an excessive basis. New rules, if not designed appropriately, could generate unintended special/squeeze protection that, in turn, could make Canada the cheapest major market to short if hedge or other funds turn bearish on global markets generally and/or Canada specifically.

2. **Factors Influencing When-issued (w.i.) Trading.** In the commentary regarding w.i. trading in Canada, the Paper cites the impact of squeezes as a factor potentially constraining trading during this pre-auction period in Canada. We would emphasize several other factors which are important causes of the decreased w.i. trading relative to the United States. First, the re-opening of issues in Canada creates the incentive for dealers and accounts to deal in the outstanding bellwether issues rather than undertaking the roll into the w.i. current coupon bond as is the case with US Treasuries. Second, the relatively small size of initial offerings of new maturities creates concerns, even at \$3 billion, about liquidity versus the outstanding previous bellwether issues. Third, Canadian accounts are much more active than US institutions in trading off-the-run bonds versus bellwether issues. Merrill Lynch Canada believes that these three influences are the principal causes of the much smaller w.i. activity relative to US Treasury auctions.
3. **Related Party Definitions.** Merrill Lynch Canada supports strongly a more precise definition of related parties in setting bidding limits given the ownership and other linkages among the various commercial banking and securities operations within the major Canadian banks. We believe that swap, proprietary/Treasury and repo positions must be included in the calculation of a dealer's bidding limit. The inventory coordination and information flows between these desks and the banks' bond trading operations are ongoing and very significant. Merrill Lynch Canada would therefore agree with the Paper's general proposal regarding related party definitions and representations of arm's length dealing and recommend including swap, proprietary/Treasury and repo positions in the total inventory calculations. (This is not to say that the information gathering for calculating such aggregate positions is insignificant. In Merrill Lynch Canada's case, it would necessitate much greater coordination with our London swap desk as well as much-increased reporting requirements.)
 - The linkages to the investment management arms of the Canadian banks must also not escape scrutiny. A bank-owned dealer that covers its investment management subsidiary during the period leading up to and including the auction is providing that fund manager with the bank's bond desk views on trading, pricing and other accounts' interest. As a result of these discussions, both the bank dealer's desk and the investment management arm will receive information regarding the other's auction

views. To prevent this information exchange during the w.i. and auction period, we believe that dealers should be precluded from speaking to their respective investment management arms. Merrill Lynch Canada views such a policy of related party exclusion as indicative of a healthy, broad-based market which is concerned about the integrity of its trading activity. Moreover, the loss of its investment management fund's flows during the auction period should not be material to a bank-owned dealer's total trading activity. There would be a significant pick-up in activity that would occur with the non-related banks' investment management arms as a result of this proposed policy's implementation.

- We would stress that SEC regulations are strict in ensuring that information firewalls exist between the asset management operations of US dealers and their respective bond trading desks at all times. Accordingly, Merrill Lynch does not deal with Merrill Lynch Asset Management in bond activity nor do other US "bulge bracket" firms undertake bond transactions or discussions with their respective investment management funds. These rigorous "self-dealing" policies were created by the regulators and are adhered to by US dealers to ensure not only the integrity of the system but also the perception of integrity. Throughout the rest of the major securities markets in the world, regulatory approaches vary widely and extensive self-dealing is permitted in a number of countries. However, the policy trend is moving toward the US approach as concerns about market integrity and investor perceptions are increasing.

Specific Comments

1. **Treasury Bill Bidding Limits.** Merrill Lynch Canada believes strongly that the existing bidding limit for Treasury Bills is far too high at 33 1/3% given both the declining Canada supply and the much smaller group of jobbers in this market. The latter factor in combination with the large size demand from banks' respective Treasury desks makes the risk of squeezes much greater in this market, a fact noted in the Paper as occurring with increasing frequency as tender sizes have declined since July 1996. We would advocate a bidding limit of 20-25% to: reduce the risk of squeezes; encourage greater w.i. trading and secondary market activity; and achieve a more "level playing field" in a market which clearly has a narrow base of bidders with very significant pricing leverage.
2. **Dealer Bidding Limits and Customer Orders.** We would recommend that the Government reconsider the proposal whereby a dealer with a short position amounting to 10% of the auction security can bid with a customer order for a combined 60% of the auction - ie, if the dealer bids on its own for the maximum additional 20% and has a customer order for another 30% (to cover this account's 10% short plus make an additional 20% bid). Merrill Lynch Canada believes that the existing system with a 20% bid limit for a dealer is working well. Customer orders have been easily accommodated with this existing maximum of 20% for combined dealer and customer bids in the vast majority of auctions as account activity remains limited in the w.i. period.
 - Instead, we support the IDA recommendation that customers be given much lower bid limits than jobbers and primary distributors. This smaller customer

bid limit would promote increased w.i. activity and pricing transparency in the pre-auction period. Given our strong belief that the existing dealer bid limit has worked well in handling customer orders, we would recommend that the dealer's own maximum bid limit and the combined dealer+customer bid limit should be set at the same amount, the current 20%. If there is a consensus regarding the merits in allowing dealers the opportunity to cover short positions to a maximum of 5% of the auction size, the dealer bid limit or combined dealer and customer bid limit would be 25% if the dealer had a short position of 5% or more in the auction security. This proposal would contrast with the Paper's proposed bid limits which would create the significant risk of two or three dealers with large short positions and customer orders winning the entire auction. Indeed, our recommended 20% or 25% limit would mean a maximum of five or four dealers would share the auction if each won their respective largest amount possible.

3. **Bidding Limits: Calculation of net long (short) position.** We would recommend that the inclusion of repo desk holdings be made explicit in the calculation formula for bidding limits. These inventory calculations should be made on the basis of which firm owns the securities rather than which dealer has borrowed these bonds during the w.i. and auction period.
4. **Reporting Thresholds.** We contend that the use of absolute dollar amounts for reporting thresholds is an inefficient mechanism given that the Government's desire is for information regarding significant holdings in the auction maturity. Rather, Merrill Lynch Canada would propose setting percentage limits (eg, 10% with a minimum size of \$100 million) beyond which reporting of positions would be required. The use of percentage limits would mean that differences in the auction size by maturity (eg, a \$3 billion 2-year versus a \$1.3 billion long bond) and in the size of outstandings would not be material to reporting needs. It would mean that the thresholds would not need to be adjusted as Canada's future auction sizes are changed to meet the projected decline in future issuance requirements. It would also reduce the dealer and account reporting requirements yet improve the Bank's monitoring by focusing the regulatory information flow upon positions that have a material impact upon bidding limits and auction awards.

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Morgan Stanley Canada Limited

Re: Proposed Revisions to Rules Pertaining to Government of Canada's Securities Auctions

Morgan Stanley Canada Limited ("Morgan Stanley") greatly appreciates the opportunity to offer to The Bank of Canada (the "Bank") comments relating to the Bank's Proposed Revisions to the Rules Pertaining to Auctions of Government of Canada Securities and the Bank of Canada's Surveillance of the Auction Process (the "Proposal"). Morgan Stanley strongly supports the goal of the Bank to ensure the integrity of the auction process for Government of Canada Securities (collectively "Government Securities"). However, Morgan Stanley is concerned that certain aspects of the Proposal may prove to

have a disruptive effect on the market for Government Securities while providing limited benefits in the context of this effort. In order to avoid undue disruption of the Government Securities market, Morgan Stanley urges the Bank to consider implementing the Proposal on a limited and selective basis. This would enable the Bank to assess both the efficacy and the impact on the market of any changes adopted. In addition, in Morgan Stanley's view the goal of the Bank to ensure the integrity of the auction process can and should be accomplished solely through changes to the rules governing that process as opposed to promulgating rules affecting trading in the when issued and secondary markets.

In order to ensure the continued liquidity of the market for Government Securities, primary distributors need access to Government Securities. Morgan Stanley proposes that the Proposal be clarified to provide explicitly that, absent compelling considerations, such as noncompliance with the auction rules, the maximum bidding percentage established for primary distributors actively engaged in the making of markets in Government Securities not be less than that established for customers. Currently, there are a number of primary distributors performing this function whose bidding percentage is less than the 20% level set forth for customers in the Proposal. Morgan Stanley feels that it would be appropriate to raise the maximum bidding level generally for such primary distributors to not less than 20%.

Morgan Stanley agrees conceptually that entities not having a strict arm's length relationship should be aggregated for purposes of calculating bidding limits. Morgan Stanley also agrees that in order for such entities to be permitted separate treatment for these purposes that "chinese wall" procedures should be required. However, Morgan Stanley believes that the development of appropriate criteria for judging the nature of the relationship among entities should be carefully considered. For example, as a practical matter, different trading desks within a bank or dealer are subject to common control. In contrast, asset management affiliates of banks are under common control with their bank affiliates only at the most senior levels of management. Such entities have separate risk managers and have traditionally acted independently from their bank affiliates. Accordingly, it may be appropriate to treat such entities as separate from their bank affiliates without requiring the imposition of a chinese wall.

Morgan Stanley further agrees that in order to determine accurately the effectiveness of the auction rules, the Bank should receive information regarding the primary distributors and the customers for whom such distributors are submitting auction bids. However, it is critical that the informational reporting requirements ultimately imposed on the market participants by the Bank be balanced against the utility of such information, so that such requirements do not discourage widespread and active participation in the market for Government Securities. Morgan Stanley believes that a number of aspects of the Proposal will impose significant burdens on both the primary distributor community as well as the general public.

For example, Morgan Stanley generally agrees that primary distributors should be required to disclose the identity of customers for whom such distributors are submitting bids (collectively the "Customer Information"). In addition, Morgan Stanley believes that the Bank should consider limiting bids that individual customers submit through any one primary distributor to 10% of the amount of securities at auction. However, Morgan Stanley feels that Customer Information should be disclosed only with respect to customer bids of \$5 million or more. This would give the Bank access to the identity of

those customers whose bids would be more likely to influence the Government Securities market while relieving primary distributors of the burden of having to disclose Customer Information in respect of potentially large numbers of small bids.

Similarly, Morgan Stanley opposes the requirement that all successful bidders confirm their bids directly with the Bank. Disclosure of the identity of bidders by primary distributors in their bid submissions would make such confirmations duplicative. In addition, imposition of such a requirement without regard to the size of the award would seem likely to discourage participation in auctions of Government Securities by the general public.

Morgan Stanley also believes that requiring primary distributors to report customer trades in the when issued or secondary markets is unnecessary. Morgan Stanley believes that there is sufficient transparency currently in the when issued and secondary markets to enable the market to react appropriately to when issued and secondary trading activity. Such requirements would also impose significant administrative burdens on primary distributors and inundate the Bank with large amounts of unnecessary information. In addition, Morgan Stanley considers maintaining customer confidentiality to be of great importance. While Morgan Stanley understands that such information is intended for use by the Bank solely to prevent market manipulation, Morgan Stanley is concerned that such disclosure may have a chilling effect on activity in the Government Securities market.

Additionally, Morgan Stanley agrees that primary distributors and participating customers should be responsible for the accuracy of the information that they submit in an auction, but believes that the proposed requirement that an annual certificate of compliance be filed with the Bank may discourage participation in the Government Securities market. Morgan Stanley feels that a less burdensome method of achieving this goal would be to provide in the rules themselves that by submitting an auction bid, an auction participant would be deemed to certify that it is in compliance with the auction rules.

With respect to the questions raised by the Bank in the Proposal, Morgan Stanley offers the following response, subject to the recommendations previously made in this letter:

- In response to the Bank's inquiry in Section 2.3 of the Proposal, Morgan Stanley estimates that it would take approximately 10 days and cost approximately \$10,000 for a participant to prepare and file the first certificate of compliance. We estimate that subsequent certificates could be prepared in approximately 5 days at an approximate cost of \$5,000.
- Morgan Stanley feels that the \$100 million threshold for requiring primary distributors to advise their customers of their net long (short) position reporting obligations contained in Section 2.3 of the Proposal is appropriate.
- Morgan Stanley feels that the \$100 million threshold for requiring customers to report their total bids (including the absolute value of their net long (short) position in the auctioned security) as proposed in Section 2.4 of the Proposal is appropriate.
- Morgan Stanley believes that the definition of "recently issued" securities as proposed in Section 3 of the Proposal includes an appropriate time period for

allowing the Bank to monitor auctioned securities.

In promulgating regulation relating to the Government Securities market, the benefit to be realized must be balanced against the burden imposed. Morgan Stanley acknowledges and strongly supports the Bank's efforts to ensure the integrity of the Government Securities auction process and believes that the Proposal, as modified to address the comments and suggestions set forth herein, would accomplish its overall objective without unduly disrupting the market.

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Deutsche Morgan Grenfell Canada Limited

COMMENTS ON THE AMENDMENTS TO AUCTION RULES

BIDDING LIMITS:

We support the establishment of separate limits for Firm and Client Bids, and the adjustment of bid limits for any cash, when issued and forward financing positions held by the Bidder.

However we believe that bid limits should not be increased for short positions because:

1. Short positions in when issued bonds can be easily created in through "roll trading" prior to auctions and
2. It would encourage the taking of short positions in when issued bonds solely to increase apparent auction participation.

It should be noted that this treatment is inconsistent with current US auction rules.

BANK OF CANADA MONITORING:

The additional monitoring suggested in the proposal seems to be designed to address both short squeezes in the auction process as well short squeezes in existing issues. The former can be monitored through regular surveillance of the when issued market, as suggested in the proposal.

However we believe that the reporting on "recently issued" securities does not effectively deal with the latter point. Issued securities can be better monitored if market participants are simply required to report all long positions held, in excess of 25% of any issue or some similar limit.

COMMUNICATION OF CLIENT TRANSACTIONS TO THE BANK OF CANADA:

The proposal mentions that Dealers will be required to report their Client's trades/positions to the Bank of Canada under certain circumstances.

Not only does this create further administrative burden for the Dealers, but it also violates Client confidentiality and may hinder our relationship with our customers.

We believe that any trade or position reporting should be undertaken directly between the Market Participant and the Bank of Canada

DEFINITION OF BIDDER:

We support the requirement that Dealer Affiliates certify they do not share information or co-ordinate strategies with the Dealer in order to be treated as a separate bidder.

We also agree that Affiliates (i.e. Parent Banks) should not submit bids through their Primary Distributors as Client, if they have highly integrated Operations with their affiliate Dealer.

However for Global Firms, such as Deutsche Morgan Grenfell Canada, the certification process would be cumbersome given the large number of affiliates worldwide. We recommend that the certification be limited to the Firm's Parent and any wholly owned subsidiary of the Parent that normally deals in a significant volume of Government of Canada securities.

ADMINISTRATIVE ISSUES:

IMPLEMENTATION PERIOD:

We recommend that Dealers be allowed a reasonable grace period to prepare for the additional reporting and certification requirements. The Self Regulatory Organizations that presently regulate Dealers typically allow a six month to one year transition period for material changes.

REPORTING POSITIONS IMMEDIATELY PRIOR TO SUBMISSION OF BIDS:

The requirement to report Firm positions immediately prior to a submission of bids, introduces certain problems. The service bureau that our Firm relies on, accounts for transactions on a batch process basis. Hence, only the previous day's closing positions would be available on the day of the bid.

The intraday changes could be extracted from the front office system. However this information would not have been scrubbed of input and other trade errors that may arise in the normal course of business. We believe that most other Dealers will experience this same problem.

Accordingly we suggest that the previous day's closing positions be reported as an alternative.

DAILY REPORTING OF CASH AND WHEN ISSUED TRADING:

Most Dealers, including ourselves will need to rely on the service bureaus to provide the additional daily reporting on cash and when issued positions, required under the proposal.

Because Dealers use only one of two bureaus, ISM or ADP, it may be more efficient for Bank of Canada submit their requests directly to the service bureaus, and consult with the individual Dealers, as necessary.

However please be aware that the service bureaus do not currently provide reporting on when issued securities. Additional programming would be required to accommodate reporting for these securities.

ANNUAL COMPLIANCE CERTIFICATION:

It is difficult to estimate the cost/time associated with annual certification as so much of it depends on the reporting processes.

However once these have been established, an annual certification should not be difficult to provide.

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Tassé & Associés, Limitée

Il m'est agréable de donner suite à l'invitation de Monsieur Montador, de la Banque du Canada, et de Monsieur Mitchell, du Ministère des Finances, à commenter le "projet sur de nouvelles règles régissant les adjudications de titres du gouvernement canadien".

Conscient de notre taille dans l'industrie et de notre volume de transactions dans le marché financier canadien, nous avons limité notre réflexion aux choses pratiques et nous vous faisons grâce de notre rhétorique philosophique.

1. Nous craignons que si vous allez de l'avant avec ce projet, la prochaine étape sera la reconnaissance pure et simple des institutions désignées comme distributeurs primaires;
2. L'application intégrale du projet élimine pour nous une source de profits. En effet, comment rentabiliser une transaction par laquelle notre soumission concurrentielle, pour le compte d'une institution, à la Banque du Canada, serait, si gagnante, confirmée directement à ce client institutionnel, au même prix ?;
3. Nos relations avec certaines institutions majeures confirment qu'elles préfèrent participer à une adjudication par l'intermédiation de firmes, comme la nôtre, puisqu'elles ne sont pas perçues comme des compétiteurs. Notre rôle d'intermédiaire de marché y mérite vraiment son titre et y est fort préféré à celui qui agit comme principal;

Le désir des courtiers majeurs d'avoir une lecture globale et transparente de toute l'activité est conflictuel avec le désir des institutions de gérer discrètement leurs transactions. Certaines institutions identifient le projet de divulgation à des courtiers majeurs comme une exposition de leur main à des compétiteur;

4. Notre perception diffère de la vôtre sur le constat que les volumes de transactions, faibles avant adjudication mais élevés le jour de l'adjudication, soient le reflet d'une crainte d'accaparement par le milieu financier canadien. Nous y décelons plutôt un problème culturel d'attitude face à ce mécanisme de lancement de nouvelles émissions et un problème structurel causé par la petitesse du marché canadien: 6 courtiers-banques dominant et monopolisent le volume des titres

obligataires transigés par toute l'industrie des valeurs mobilières et l'existence d'une très forte concentration des autres institutions. Au nom de la grandeur de leurs institutions, les canadiens en ont réduit la compétitivité domestique. Pour permettre à nos institutions de concurrencer à l'échelle globale, on a permis la création d'un oligopole national. **Vous devrez donc importer la compétition !**

Votre analyse des effets négatifs de l'accaparement mérite notre respect et notre appui. Nous nous reconnaissons en effet en victime très éprouvée lorsqu'un accaparement se produit sur un titre servant de référence ("benchmark") à l'établissement des prix d'autres valeurs ou pire, d'autres émetteurs. Dans ce sens notre activité dans le marché municipal au Québec, primaire et secondaire, est affectée. Il en va naturellement de même pour notre activité d'arbitrage ("trading") dans les titres de la Province et de l'Hydro Québec.

Nous vous soumettons respectueusement que l'accaparement est un risque naturel propre à la petitesse et à l'oligopole du marché canadien et devient un problème suite au manque d'éthique de certains participants du marché obligataire. L'emphase devrait donc porter davantage sur un code de déontologie que sur un code rigide d'adjudication.

Nous vous remercions de l'opportunité offerte à vous présenter nos commentaires et nous profitons de l'occasion pour vous assurer de notre usuelle diligence.

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Pension Investment Association of Canada

SUBMISSION

IN RESPECT OF PROPOSED REVISIONS TO RULES PERTAINING TO AUCTIONS OF GOVERNMENT OF CANADA SECURITIES

The Pension Investment Association of Canada (PIAC) is the representative Association of pension fund organizations in Canada in pension investment matters and related issues. At December 31, 1995, PIAC's 122 Member funds collectively managed over \$325 billion in pension assets on behalf of over 6.5 million Canadians. Of the total assets, some \$ 40 billion was invested in domestic bonds. While the PIAC membership includes many pension funds which are of a size that inhibit their participation in auctions, some of our Members will experience the significant impact on their operations that the proposals create.

In general, PIAC is supportive of any procedural changes to the auction process which would improve the fairness, distribution and effectiveness of primary securities distribution. Limiting participation by each account or dealer to 20% of the announced auction size clearly is a reasonable method of creating a level playing field for all participants and ensuring that supply at each auction will have a fair degree of distribution among participants. While PIAC appreciates that the reporting of investor participation at each auction may be necessary from the Bank of Canada's perspective in order to verify compliance with the 20% participation rule, nevertheless, there is concern

about the administrative and procedural implications of the proposed revisions.

The primary area of concern relates to the inclusion of holdings of relevant existing issues in the calculation of the 20% auction participation limit. The formula, in PIAC's view, will regulate or constrain secondary market activity because it effectively restricts auction participation based upon existing security holdings and not merely upon proposed participation in each new securities auction. This specific element of the proposed revisions cause PIAC concern for three reasons.

1. There are several legitimate reasons for a bona fide investor to hold more than 20% of an outstanding security issue. Restricting participation by accounts in the reissuance of a security in these circumstances seriously reduces the investor's flexibility and fund management capability.
2. The administrative and procedural requirements proposed have serious implications. Participation in every proposed auction would carry with it the added burden of reporting existing holdings in relevant securities where no such requirements currently exist. And there are several unanswered questions such as:
 - Are holdings to be reported on a trade date or settlement date basis?
 - Are holdings to be reported inclusive or exclusive of repo activity?
 - What is the cutoff date for reporting net holdings?
 - Are stripped holdings to be reported on a reconstituted basis?

As well, there are several definitional issues which require clarification. Clearly, this procedure is more complex than is apparent from the discussion paper.

3. What is presently a straightforward investment decision is significantly complicated by the proposed revisions insofar as investors, prior to each auction, would be required to review current holdings and compare proportional holdings to proposed new participation to verify that such new participation would not violate the aggregate 20% limit. Similar in nature to the 20% foreign property rule, the proposed limit, as presently constructed, must be monitored, managed and incorporated into the investment decision. While the 20% FPR limits holdings in all classes of securities, the draft proposal limits holdings to 20% of each individual debt issue for those investors wishing to participate in auctions. Admittedly, this is not a significant constraint at present given the amount of treasury stock outstanding, however, as the net debt outstanding begins to decline and issue size concomitantly declines, this aspect of the proposed revisions would begin to adversely affect more and more investor participants.

It should be clear that PIAC does not favour a limit on participation in auctions which is computed by reference to existing holdings of securities. As investors and not market makers, PIAC Members are opposed to the new constraints imposed on their holdings as a consequence of merely wishing to participate in auctions. The alternative is to add to holdings only in the secondary market at higher prices and limited stock in desirable issues.

Consequently, PIAC cannot support any initiative to include existing holdings in the computation of the 20% participation limit and the attendant monitoring, managing and reporting requirements which significantly complicate the investment decision.

Alternatively, PIAC recommends a more reasonable solution and one which limits its impact to only the auction process which is a stated objective of the proposed revisions. All participants should be limited to 20% of new securities offerings. No reference would be made to the existing holdings of investors in that specific maturity. Each participant would be assigned an identification number (ID#) and all submitted bids would be accompanied by the unique ID#. Compliance with the 20% participation limit could be readily verified by the Bank in a straightforward and uncomplicated manner. This recommendation would negate the pre-auction calculation and reporting of a participation limit which encompasses existing holdings (and its administrative implications) and would simplify the pre-auction calculation to 20% of only new issue size without artificially constraining bona fide ownership of Government debt.

While this recommendation still represents a complication or constraint in participation in auctions when compared with the present process, the benefit of an improved auction process and the resultant monitoring capability would, from the perspective of pension fund managers, represent a justifiable modification. We also believe the recommendation meets the objectives of the Bank and the Department of Finance.

Respectfully submitted on behalf of PIAC's Bond Committee.

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Royal Bank Investment Management Inc.

Re: Discussion Paper 1. "Proposed revisions to the rules pertaining to auctions of Government of Canada securities and the Bank of Canada's surveillance of the auction process."

Thank you for the opportunity to comment on the above noted discussion paper. As you may be aware, Royal Bank Investment Management Inc. ("RBIM") is the primary investment advisor for the Royal Mutual Funds and acts as investment advisor for a number of other clients with full discretionary authority to invest on their behalf. RBIM currently has assets under management of over \$20 Billion of which approximately \$6 Billion is held in Royal Mutual Funds' Canadian T-Bill, Money Market and Income Funds including RoyFund Canadian T-Bill Fund (Canada's largest T-Bill fund with assets of \$4.22 Billion).

As our clients are substantial end-investors in Government of Canada securities we have a significant interest in the maintenance of an open, efficient and fair auction process. Accordingly, we fully support your goal of maintaining the confidence of participants and end-investors in the process. However, we have serious concerns that the limitations and compliance procedures referred to in the Discussion Paper will in fact detract from the efficiency of the Government of Canada primary debt market by encouraging participation in the secondary market. It is our view that on balance, the existing auction rules are generally adequate and that auction related squeezes can be dealt with

effectively through less intrusive measures such as the reissuance of squeezed maturities.

Specific Comments on the Discussion Paper

Confidence in the Auction Process

The Discussion Paper refers on numerous occasions to the importance of maintaining the confidence of participants and end-investors in the auction process. Although it is clear that auction related squeezes adversely effect those caught in the squeeze, the Discussion Paper does not present any evidence which in fact supports the argument that there has been an erosion of confidence generally in the auction process as a result. We are of the view that market participants and their customers on balance continue to have confidence in the existing process and accept the risk of economic loss resulting from a squeeze as a tolerable consequence of our current auction process as a whole. In our opinion, this risk is preferable to a system of limitations and regulatory restrictions which will, in our view, discourage participation in the auction process.

Bidding Limits

The Discussion Paper proposes that a customer (such as RBIM) would be allowed to submit a maximum bid equal to 20% of the dollar value of bonds (33 1/3% of the dollar value of treasury bills) being auctioned (per tranche) less its net long position (per tranche) in excess of the product of its percentage bidding limit and the dollar value of any outstanding stock of the security being auctioned.

RBIM acts as investment advisor for over 20 major accounts that are potential purchasers of Government of Canada securities. Under the proposed rules, RBIM would be required to report a combined net long position that aggregates all net long (short) positions under its control. As a result of our significant combined holdings of T-bills and bonds (primarily accumulated through direct investments rather than through when-issued contracts as suggested by the Discussion Paper) RBIM will be effectively locked out of the auction process for many issues. This will have a significant effect on our ability to make optimal investment decisions for our clients by requiring us to rely primarily on the secondary market and purchase other (and potentially less desirable) maturities that are not currently being auctioned.

Administration

We believe that the additional administrative burden that will be placed on primary distributors and their customers is excessive. With potentially 20 accounts participating in any given Government of Canada issue, the administrative burden and associated costs which will be incurred by RBIM on behalf of its clients will be substantial. We will also be required to set up a system of direct reporting to the Bank of Canada (rather than through primary distributors) to maintain the confidentiality of our clients and their holdings.

Circumventing the Process

Developing rules and monitoring procedures for the auction process alone will not achieve the desired result of controlling manipulation of the government debt market. As is noted in the Discussion Paper, a rules based approach is unlikely to work well for

secondary market squeezes. The entire process referred to in the Discussion Paper can be circumvented by any market participant who chooses not to participate in the auction process. Large net long positions will continue to be created before and after auctions through the when issued and secondary markets. We believe that this will in fact lead to a reduction in the number of participants in the primary distribution market which will have negative implications for market liquidity and efficiency. We are also concerned that a rules based approach for one segment of the market will not be effective in deterring manipulative practices by foreign accounts and question how such accounts will be sanctioned if they engage in manipulative practices in the primary or the secondary market.

Conclusion

In our opinion, manipulation of the auction process is primarily a trading related problem rather than an investment management issue. The proposed bidding limits, administrative and compliance procedures adversely impact investment advisors (such as RBIM) and their clients who are in fact the end investors in Government of Canada securities without achieving the objective of reducing market manipulation by other participants. Creating a more restrictive auction environment will discourage participation, impair market liquidity and generally reduce the efficiency of the auction process. Each of these will in turn diminish confidence in the process and lead to higher borrowing costs for the Government of Canada. Accordingly, we urge you to reconsider the proposals contained in the Discussion Paper in light of our comments and those of other market participants.

We appreciate your efforts to encourage a consultative process which has provided us with the opportunity to comment on these proposals. If we can be of assistance in clarifying any matters or providing further information with respect to any of the concerns identified, we will be pleased to do so.

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Caisse centrale Desjardins

Nous avons parcouru avec un vif intérêt le document de travail qui énonce diverses propositions visant à mettre un terme à l'accaparement des titres du Trésor fédéral. Nous en partageons les objectifs. En effet, en notre qualité de distributeur initial, nous souhaitons que les obligations du Gouvernement du Canada soient le moins vulnérables possible aux manipulations contraires aux forces du marché. Nous désirons contribuer à rendre le marché canadien plus liquide et plus transparent. La forme de la courbe des taux d'intérêt au Canada doit refléter le consensus des anticipations et être libre de distorsion.

En revanche, l'ensemble des propositions contenues dans le document nous semble beaucoup trop contraignant et sa mise en place ardue. Le calcul des limites, leur répartition entre "propre compte" et "client", les divulgations, les surveillances... cela crée un encadrement juridico-administratif qui convient mal à l'exercice des adjudications. De plus, il sera toujours possible pour un intervenant de faire transiter ses transactions par un intermédiaire étranger afin de conserver son anonymat. Si nous partageons vos objectifs, nous ne sommes pas des plus enthousiastes quant aux moyens proposés.

Nous profitons de l'occasion qui nous est offerte pour vous soumettre notre proposition. Nous croyons que le marché des prises en pension peut non seulement révéler s'il y a manipulation sur un titre, mais s'avérer également très efficace pour y mettre fin. À cet égard, la Banque du Canada pourrait émettre des obligations de façon ponctuelle sur le marché des prises en pension, pour les retirer de la circulation aussitôt que tombent les pressions sur les prix.

À notre avis, cette méthode offre l'avantage d'être complètement transparente et ne nécessite pas la mise en place de règles et contraintes additionnelles.

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Gestion de portefeuille Natcan

OBJET: Adjudications de bons du Trésor et d'obligations du gouvernement du Canada

Après lecture du document sur votre projet de modifications des règles régissant les adjudications de titres du gouvernement canadien, nous aimerions vous faire part des observations suivantes:

Nous sommes, de façon générale, tout à fait d'accord avec les modifications proposées. Par contre, nous sommes préoccupés par certains points sur lesquels nous aimerions avoir des précisions:

- Selon votre document, la limite maximale par soumissionnaire lors de l'adjudication est de 20 % pour les obligations et de 33 1/3 % pour les bons du Trésor. Mais qu'en est-il pour un gestionnaire de portefeuilles? Sera-t-il considéré comme un seul soumissionnaire ou bien comme autant de soumissionnaires que de clients qui auraient participé à l'adjudication?
- Au point 2.2 du document il est mentionné que «pour être identifiés comme soumissionnaires distincts, les établissements appartenant à la même organisation doivent certifier qu'ils n'effectuent aucun échange de renseignements sur les rendements, les montants, les positions qu'ils détiennent ou envisagent de détenir ni les stratégies d'investissements qu'ils appliquent à l'occasion de l'adjudication des titres concernés.»

Gestion de portefeuille Natcan appartient majoritairement à la Banque Nationale, tout comme Lévesque Beaubien Geoffrion. Selon la réglementation, nous ne pouvons fournir aucune information sur nos positions actuelles ou futures. En tant que client, si nous désirons participer à l'adjudication des titres canadiens, nous sommes dans l'obligation de fournir certaines informations aux distributeurs initiaux (dont Lévesque Beaubien Geoffrion). Est-ce donc dire que selon la réglementation nous ne serions plus en mesure de participer aux adjudications par l'entremise de Lévesque Beaubien Geoffrion, même si les informations fournies peuvent être les mêmes que celles divulguées à d'autres distributeurs initiaux?

Nous espérons que ces commentaires sauront vous être utiles dans l'élaboration du document final.

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Nexus Investment Management Inc.

A Response to the "Proposed Rules Pertaining to Auctions of Government of Canada Securities and the Bank of Canada's Surveillance of the Auction Process"

I am pleased to have the opportunity to respond to the discussion paper, "Proposed Revisions to the Rules Pertaining to Auctions of Government of Canada Securities and

the Bank of Canada's Surveillance of the Auction Process" (Proposed Revisions Paper). Given the massive fundamental change in many aspects of the workings of the capital markets over the past few years, it is timely to consider possible improvements to keep Canada's capital markets at the forefront of sophistication and development. As an aside, to those who would espouse that markets will evolve efficiently of their own accord and need as little outside interference as possible, one need only consider the successful introduction of the all auction system, or the benchmark borrowing emphasis of the last few years.

In the past ten years, the distinction between Primary Distributors and Jobbers (PD & Js) and accounts has blurred considerably. Traditional responsibilities and privileges are not nearly as beneficial for dealers as they once were. Many accounts legitimately have capital market requirements that force them into the markets on a much more active basis than they did in the past. Securitization, leveraged directional investment, and interest rate swapping are just three examples of legitimate account behaviour that generate much more intensive activity in the capital markets. My own comments are heavily influenced by using this review and consultative process to consider whether the present blurring of distinction between accounts and dealers is an unavoidable evolution to the market or whether the system can't be changed in order to re-emphasize the necessary distinctions and privileges that have served the markets well in the past.

From my present perspective, I am disadvantaged in responding to the technicalities of many of the rules put forward and their consequences to dealers and accounts alike. I believe that a workable definition of related parties can be arrived at with sufficient dealer input and I will leave to both the Jobber Committee and the IDA Capital Market Committee to comment on the viability of some of the rules proposed and the consequences of some of the changes outlined from this rules based approach.

General Background - The Need for Incentives and Privileges

It is almost counterintuitive to think that the auction process needs more attention and fine tuning at a time when prospectively the government will be relying on it less than at any time in the last twenty years. Nonetheless, maintaining an efficient working market is a top priority given the outstanding stock of debt. The consideration, set aside in the present paper, of the negative consequences in "squeezes" and "corners", must eventually be considered. The best way for those with oversight responsibility to ensure that the market functions efficiently is to ensure that sufficient incentives are in place to encourage accounts and dealers alike to dedicate capital, human and financial, to the Canadian marketplace.

As it is presently contemplated in the Proposed Revisions Paper, there seems to be very little to differentiate accounts and PD & Js. In fact, in many instances, an account appears to have greater access to the tenders than does a moderately sized Primary Distributor. As the system is presently constructed and contemplated in the future, the privilege of being a PD & J is basically unrewarded. It is important to at least consider whether the current system or the modifications in the Proposed Revisions Paper provide the incentives to encourage PD & Js to publish research, to bid aggressively at auctions or to make tight prices to customers. I believe that there is an opportunity to address this imbalance with modification to the auction system. If left unchanged, there is the risk that the Bank of Canada's influence on PD & J behaviour will continue to be undermined. Ultimately it will impair its ability to gather information on trading activity, and its ability to insure

that trading behaviour counter to the integrity of the capital markets does not occur.

In the case of accounts two very basic requirements need be met:

Fairness: There must be the belief that investors are on a level playing field, that pricing and information is freely available, and that the market is free of "tampering" or "collusion" amongst the major players.

Liquidity: Investors of all sizes, but especially large investors, must feel that they can commit capital efficiently as compared to substitute investment alternatives elsewhere.

If the above requirements are met, it should be sufficient that accounts of all natures will feel that the market is worth devoting capital and effort to.

In the case of the Bank's stable of Primary Dealers and Jobbers, the above two conditions must also be fulfilled. However the nature of what is fair to a PD & J is different than for an account.

Fairness: In the case of PD & Js, they too must believe that there is a level playing field, - that pricing and information is freely available, and that the market is free of tampering or collusion. In addition though, they have much of the responsibility in both the primary and secondary markets that insure that the two preceding conditions exist for investment accounts. Over the long term, PD & Js require some quid pro quo for these obligations to the market place, and logically, it should be that they have the ability to earn reasonable economic rents from the application of capital and resources to the distribution and intermediation function.

Liquidity: Most dealers would now agree, that large liquid markets can still provide sufficient profit opportunity for a well run distribution business. Although it is not universally agreed, the overwhelming consensus of opinion would support that in an environment where market making and distribution provide some economic rents, greater liquidity should generate higher turnover, greater breadth of account participation and consequently lower risk returns than in illiquid markets.

It is clear from the above, that I am unconvinced that accounts deserve or warrant a role in the *competitive* auction process. I am sceptical about the willingness of many accounts especially domiciled abroad, to comply with the reporting requirements as they are outlined in the Proposed Rules Paper. (However, others are clearly more able to offer an opinion on this issue.) Additionally, in the event of non-compliance, the jurisdiction of Canadian authorities would be somewhat in question. It would be inappropriate for the integrity of the auction process to be besmirched by an account over which Canadian authorities didn't have conclusive ability to penalize or sanction. However, it is important that the auction process encourage as much participation and interest from the ultimate providers of capital to the markets. I believe there is an opportunity to address this issue and improve access to accounts wishing to deal in the Canadian market.

Recommendations

The following two suggestions are meant to build upon the general theme of offering positive incentives rather than rules and penalties to induce appropriate interest and behaviour in the primary as well as secondary market. They will hopefully encourage PD

& Js to commit resources to the market, and allow accounts with trading or investment strategies to execute them in a market that is fair and liquid.

Non-Competitive Bidding:

The ability to purchase securities at the tender non competitively should be greatly expanded and offered only to accounts. This is meant to address the desire of many accounts to lower their transaction costs by purchasing when the market is at its most liquid.

- Non-competitive bids would be limited to some fixed percentage of the tender, say 30%, and each account would be restricted to no more than 7.5% of the auctioned amount.
- Non-competitive bids would be submitted by 12:00 Noon directly to the Bank of Canada. The Bank would maintain the right to reject any bid that it felt was inappropriate.
- Results of this "pre-tender" would be made public at 12:15, and if in excess of 30% was tendered for, fills would be apportioned on a pro-rata basis. When these results are known, accounts would be free to buy in the WI market to meet their investment requirements.
- PD & Js would have the benefit of knowing how much of the tender was already spoken for when they submit their own bids.
- Accounts wishing to participate in this expanded non-competitive process would have to register with the Bank of Canada. Only one arm of an account would be entitled to register for this status.
- There would be no attempt to restrict WI positions held by accounts.

Dealer Incentives:

PD & Js require a positive inducement to bid consistently and aggressively at the tenders.

- Primary Dealers should be allowed to bid for up to 15% of an issue although the Bank of Canada may wish to restrict some PDs to amounts smaller than this. A PD's access would be based on its performance at the auctions as well as its secondary market presence. These would be the only determinants of what their limit at the tenders would be. *It goes without saying that, the more explicit and objective this can be outlined, the better.*
- This recognizes that PD's have greater responsibilities and a different role in the marketplace than do accounts who can be more opportunistic. Accordingly, they would have greater privileges in the auction process than do accounts.
- A consequence may be that some PDs choose to relinquish their status and avail themselves of the limit of 7.5% accorded accounts at the non-competitive tender (though they would be subject to pro-rata fills when demand exceeded the 30% limit).

- In recognition of their responsibilities in both the secondary and primary markets, Jobbers should be allowed to bid for up to 25% of any tender.
- Additionally, in order to reward Jobbers specifically for performance in the auction process. I propose that an option be granted for 10% of the amount allotted to any Jobber who wins more than 10% of the amount available at an auction.

Consider the following example:

Auction amount: \$2.80 Billion

Non-competitive Bids (30% X \$2.80 Billion): \$0.84 Billion

Amount available to PD & Js: \$1.96 Billion

Amount allowed - Jobber (25% X \$2.80 billion): \$700 Million

Amount allowed - PD (15% X \$2.80 Billion): \$420 Million

Option threshold amount (10% X \$2.80 Billion): \$280 Million

Jobber 'A' wins \$500 Million (approximately 17.8%) competitively at the tender. He also earns an option to draw down \$50 Million (10% X \$500 Million) at any time up until when the issue would normally trade for regular settlement.

Jobber 'B' wins \$300 Million (approximately 10.7%) competitively at the tender. He also earns an option to draw down \$30 Million (10% X \$300 Million) at any time up until when the issue would normally trade for regular settlement.

Jobber 'C' wins \$200 Million (approximately 7.1%) competitively at the tender. He has no option on any excess supply.

In the most extreme example, where there was no non-competitive interest, and four jobbers each won 25% of the auction, the issue size would be 10% bigger than announced. However, in practice the extra bonds issued, would be material only to those jobbers who earn them and ought not to pose a problem from a debt management perspective.

Summary

Without distinctions drawn in the auction process between PDs, Jobbers and accounts, the auction and secondary markets risk being governed by a much more opportunistic approach by these players than in the past. This will undermine the integrity of the market, and reduce the ability of the Department of Finance and the Bank of Canada to influence behaviour that is in the long run best interest of the markets. The present system has evolved to where there is little distinction between these major players and little incentive to aspire to a deeper commitment to the secondary and primary markets other than as a subsidy to the broader relationship with the Government. Eventually, this subsidization will prove unsustainable.

I believe that the present system does not acknowledge sufficiently the important role that jobbers play, and does not induce PD's to aspire to jobber status. The changes contemplated in the Proposed Revisions Paper seem to extend this to another level, by

granting equal or better privileges to accounts than they do to PDs.

If government and private sector forecasts prove to be true, government reliance on the auction process will continue to lessen for a number of years. The everyday workings of the bond market will become much more technical as it has in the treasury bill market in the past 18 months. This is an environment where authorities will need to understand well the various forces at play in the market. A system with privileges, responsibilities, and incentives ought to be more effective in maintaining quality and efficiency in the Canadian capital markets than the system as it has presently evolved. It will certainly give the Bank of Canada greater persuasive ability in surveying either the primary or secondary markets.

These recommendations are meant to further the liquidity and fairness of the market to all its major constituents. No matter what the level of public borrowing we encounter in the coming years, the largest beneficiary of a broad commitment from PD & Js and accounts is the Canadian taxpayer in that efficient markets lower the cost of all borrowing and encourage greater investment of private capital. I would be delighted to discuss further the suggestions and comments proposed should there be any questions or interest.

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Gouvernement du Québec, Ministère des Finances

Objet: Nouvelles règles d'adjudications

Afin de donner suite au premier document de travail du 19 décembre 1996, nous avons le plaisir de formuler les commentaires suivants:

- Nous sommes d'accord avec le projet de modifications et avec les mesures proposées pour réduire les risques de manipulation ou de collusion avant ou pendant les adjudications. Il est évident qu'il est très important que la crédibilité du marché soit protégée et que tout soit mis en oeuvre pour se prémunir contre toute manipulation.
- Pour assurer une saine distribution, il nous apparaît particulièrement souhaitable qu'une réglementation efficace soit instaurée et ce, afin d'assurer une protection de liquidité adéquate sur les titres émis par la Banque du Canada. Nous sommes parfaitement conscients des problèmes observés dans votre premier document de travail. La disparition de plusieurs joueurs sur le marché canadien et la réduction du volume de vos programmes d'emprunts ont créé un environnement pouvant provoquer des accaparements excessifs et des perturbations au niveau de certaines échéances de marché.
- Il est certain que si les investisseurs étrangers qui participent au financement canadien constatent l'effet de manipulation dont il était fait mention, ils exigeront une prime vis-à-vis de ce risque. Dans ce cas, il y aura donc un coût additionnel pour tous les emprunteurs canadiens. Il faut aussi être conscient que les titres de référence servent de base pour de nombreux emprunteurs tels que nous et ce, pour la fixation des produits dérivés. Dans la mesure où le doute s'installera vis-à-vis des éléments de fixation de référence, ces derniers exigeront une prime

additionnelle pour négocier les produits dérivés canadiens. Nous devons donc déboursier davantage pour les mêmes immunisations.

Nous comprenons que suite aux consultations un deuxième document de travail sera publié que nous apprécierions recevoir.

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J. Zechner Associates Inc.

I recently reviewed the proposed changes to the Government of Canada bond auction process and my reaction was one of disappointment over the lack of substantive improvements. While the proposals may reduce the possibility of a squeeze, thereby protecting the profitability of your primary dealers (for whom no tag - days were planned anyway) they do nothing to improve the transparency of the Canadian bond market. As well, the proposals will discourage customer participation in the auctions, and ultimately they may result in higher rather than lower borrowing costs for the Government of Canada.

Transparency: The single biggest problem facing the Canadian bond market is not the potential for occasional squeezes in Government of Canada securities, but the constant lack of transparency. The proposed changes, however, do not improve the flow of information available to investors, because the additional information to be collected by the Bank of Canada will not be disseminated.

Customer participation: The increased reporting requirements for end-investors who participate in future auctions can do nothing but be a bureaucratic irritant and discourage that participation. In addition, the proposals do not address customer concerns that primary dealers can adjust their own bids after receiving customer bids. Bids for their own accounts compete directly with the bids submitted by end-investors, but the current process gives a distinct advantage to the dealers. I would recommend allowing investors the opportunity to submit their bid directly to the Bank of Canada as U.S. auctions permit.

Borrowing costs: By not improving the transparency of the bond market, and by consolidating the information advantage of dealers, the proposed changes do little to improve the efficiency of the market. Only by improving the efficiency can the Government of Canada expect long term savings for its borrowings.

Rather than trying to correct a relatively minor problem within the bond market in these proposed changes, the Bank of Canada should have concentrated on more substantial issues. Specifically, the availability of inter-dealer brokers screens to investors has been discussed ad nauseum for years with no result. Even the inadequate CANPX proposal, favoured by the dealers' lobby group, has not come to fruition. Allowing competition among the surveyors of information would not be a bad thing to consider.

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Aurion Capital Management Inc.**Re: Government of Canada Bond and Bill Auctions**

I am writing in response to your discussion paper dated December 19, 1996 entitled "Proposed revisions to the rules pertaining to auctions of Government of Canada securities and the Bank of Canada's surveillance of the auction process".

I very much endorse the stated objectives of the proposed revisions. It is of vital importance that the integrity of the auction process be preserved for all the reasons that outlined in the paper. I found the discrepancy in the level of pre-auction trading of "when issued" securities between our market and the U.S. market to be particularly striking. The smaller size of our market and the greater opportunity for participants to "game" the auction process is evident. It therefore makes eminent sense to put in place clear and enforceable rules that to give all the players the confidence that they need to participate without fear of being victimized.

The rules requiring both dealers and clients to disclose their aggregate positions are certainly an important step in the right direction. The greater the confidence that everyone has in the auction process, the greater will be their participation and the overall level of market efficiency. I defer to others to determine the exact limits and levels of disclosure required.

I thank you for the opportunity to comment on this discussion paper, and I would welcome any questions you might have.

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Canadian Life and Health Insurance Association Inc.

Further to our meeting in late January, a number of our industry's investment officers have now had the opportunity to review the discussion paper called "Proposed revisions to the rules pertaining to the auction of Government of Canada securities and the Bank of Canada's surveillance of the auction process", released last December by the Bank of Canada and the Department of Finance.

The comments that have been brought to my attention deal with three areas: the definition of a "single bidding entity", the equitable treatment of all participants when enforcing the rules, and confidentiality of information. These comments are as follows:

- Limiting the size of bids by any single entity will increase the integrity and liquidity of the market while reducing market manipulation. The Bank must be certain to differentiate between entities which are distinct fiduciaries and those which are in essence one combined entity. If the entities are not clearly differentiated, an unfair advantage will accrue to some participants.
- The ability of the Bank to effectively monitor and enforce the rules on an equitable basis is key to market confidence and the success of the new initiative. If all participants are not treated equally, the bidding at the auction will be less efficient and less liquid and the rules will do little to enhance the Canadian fixed income markets. A more thorough discussion of the monitoring process and clarification of who is responsible for sanctioning an entity that abrogated the procedures would inspire greater confidence in the process.
- Confidentiality of information is necessary to instill confidence in market participants that the bidding procedures are fair to everyone and that all bidders have access to the same information. Mandatory direct bidding instead of a choice of direct or indirect bidding, would result in equitable treatment of all participants.

We appreciate very much the opportunity to comment upon the Bank's proposed new bidding procedures. We would be pleased to discuss any further initiatives aimed at increasing the integrity and efficiency of the Canadian bond market while protecting the principles of a free market.

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Unattributed / Auteur désirant garder l'anonymat

Comments on the Proposed Revisions to the Rules Pertaining to the Auction of Government of Canada Securities follow in point form.

1. Separating customer bids from primary distributors own bids is a very good idea. This will essentially make it more difficult for bidders to mask their positions. To this end proper identification of non arms length relationships is also critical.
2. Obtaining bid certification and verification with stiff penalties for non-compliance or wrong doing is also a step in the right direction. Ideally it might be better if the Bank of Canada could obtain information directly from CDS. The potential problems with this step however are that given the fast moving nature of the capital markets, dealer or customer positions can change between the time the positions are calculated and noted on the certificates and the time that the certificates are received by the Bank. How does the Bank propose to deal with this?
3. Bidding limits mitigate the amount of securities any one entity may be able to bid for at auctions, but again there is a similar problem to the one outlined above. A distributor or customer may have room within the set limit to submit a bid at 12:30 PM. But that room could disappear between 12:30 and 1:15 PM when the auction results come out. As a result the bidder may end up holding more securities than the set limit. There does not seem to be a provision for these instances in the discussion paper. E.g. Is the bidder responsible for immediately reporting such changes to the Bank or not?
4. Bidding limits may also encumber genuine portfolio strategies, where investment managers have to target certain maturity dates because of client or guideline restrictions on the portfolios. One way to get around this problem may be to ascertain from the bidders what type of strategies the securities are targeted towards. This could be done by obtaining something similar to a certificate of compliance, with penalties again being imposed for misinformation. Then people with a genuine requirement for the securities could be awarded higher limits. Also issue sizes for such specific maturity dates could be made larger than normal.
5. We agree with the suggestion that when issued positions of the bidders should be netted when calculating the maximum portion of the tender to be awarded. And also with the idea that if issues are being squeezed in the secondary market, there should be a provision for re- opening them.

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Unattributed / Auteur désirant garder l'anonymat**SUBJECT: Discussion Paper Re: Proposed Changes to the Auction Rules**

This letter is in response to the discussion paper on the proposed changes to the auctions of Government of Canada securities. As you are aware, we participate in both the Canadian bond and treasury bill markets. Government of Canada treasury bills represent a significant portion of our liquid reserves and Government of Canada bonds are used extensively in our borrowing and risk management programs. It is therefore in our best interest to support initiatives that are intended to promote greater efficiency and liquidity in the treasury bill and bond markets.

We support the Bank of Canada's initiatives set forth in the paper aimed at reducing potential "squeezes" of securities in primary distribution. Specifically, we support the reopening of securities to relieve market pressures and the creation of larger benchmarks for Government of Canada bonds. We would not recommend lowering the maximum bidding limit from the proposed 20% of the value of bonds being auctioned (33 1/3% of the dollar value of treasury bills) less the adjustment for net long positions. This reflects the accumulation of liquid reserves which occurs during our monthly cash flow cycle and upon settlement of large bond issues. In addition, the threshold amount of \$100 million for reporting requirements seems somewhat low. Perhaps a more defined threshold (eg. \$100 million of one-year equivalent securities) is more appropriate given our normal transaction size. Finally, given the proprietary nature of our business, we would elect to report aggregate positions in a given security directly to the Bank of Canada.

The proposed changes to the auction rules also have administrative implications for us. Although we are prepared to deal with the proposed changes regarding the confirmation of securities and monitoring processes, we support initiatives that minimize the administrative impacts.

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Unattributed / Auteur désirant garder l'anonymat

Objet: Adjudications de Bons du Trésor et d'Obligations du gouvernement du Canada.

En réponse à votre demande, nous avons examiné la nouvelle proposition de fonctionnement des adjudications des titres du gouvernement du Canada. Le commentateur voit favorablement une telle politique visant à assurer une meilleure efficacité des marchés primaires, ayant remarqué à quelques occasions dernièrement un certain manque de liquidité sur le marché des adjudications.

Les plafonds de participation aux adjudications semblent généreux et adéquats. Advenant que nous voulions utiliser ce marché, les limites proposées sont amplement suffisantes pour combler nos besoins même dans un avenir éloigné.

Traditionnellement, nous utilisons le marché secondaire pour nos investissements, tant dans le court que le long terme, et nous jugeons que l'arbitrage est suffisant sur ce marché. Nous sommes également actifs sur le marché des titres avant émission, sans toutefois aller jusqu'à l'adjudication, ce qui ne nous pose aucun problème. A ce titre, nous ne croyons pas que des mesures d'intervention soient nécessaires sur le marché avant émission.

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Unattributed / Auteur désirant garder l'anonymat

Sujet: Projet de modification des règles régissant les adjudications de titres du gouvernement canadien et la surveillance de celles-ci par la Banque du Canada

Le commentateur désire profiter de l'opportunité offerte par la Banque du Canada de commenter le sujet en rubrique.

Le commentateur partage l'objectif poursuivi par la Banque du Canada, soit "d'améliorer le fonctionnement du marché des titres d'État". En effet, certains comportements aberrants peuvent être observés à l'occasion dans les marchés obligataire et monétaire canadiens. Bien que l'objectif soit souhaitable, nous avons des réserves quant aux moyens proposés pour l'atteindre.

En effet, nous constatons que la teneur générale des moyens suggérés aura pour effet d'augmenter la réglementation du processus d'adjudication, de diminuer la flexibilité des opérations des mainteneurs de marché dans le cadre des adjudications et d'augmenter quelque peu la charge d'intendance des investisseurs. Nous croyons fermement que la liquidité et le fonctionnement efficace des marchés financiers ne peuvent être décrétés par réglementation et législation ou être assurés par une multiplication des termes et conditions à respecter. Nous pensons au contraire que la liquidité et l'efficacité des marchés seront favorisées dans la mesure où l'ensemble des agents économiques (y compris l'émetteur) pourront intervenir de façon rationnelle.

La Banque du Canada suggère que les limites de soumission à l'adjudication tiennent

dorénavant compte des positions acheteur nettes et des positions vendeur nettes dans les titres sous adjudication. Nous pensons qu'une telle mesure est susceptible d'engendrer des distorsions dans le marché secondaire des titres sous adjudication.

En effet, la Banque du Canada exige des mainteneurs de marché une présence assidue et agressive lors des adjudications. En d'autres termes, avec les règles proposées de calcul des limites de soumission, elle encouragera les mainteneurs de marché à se présenter aux adjudications avec des inventaires de titres sous adjudication aussi faibles que possible, réduisant d'autant la liquidité de ces titres. Ceci sera particulièrement vrai lors des quelques jours précédant la première réouverture des titres sous adjudication, les montants en cours étant limités. Par conséquent, nous ne voyons pas quel est l'avantage des investisseurs à detenir un titre qui fera l'objet d'une adjudication.

La modification du calcul des limites de soumission est de nature à diminuer ponctuellement l'efficacité du marché lors des quelques jours précédant une réouverture d'une émission. Nous croyons que cette proposition pourrait soumettre le marché des titres du gouvernement canadien à des distorsions suffisamment importantes qui nous forceraient à revoir nos stratégies quant à l'acquisition de titres du gouvernement canadien n'ayant fait l'objet que d'une seule adjudication. Il est possible que les effets pervers sur le mécanisme de prix soient tels que nous évitions de façon systématique les titres n'ayant fait l'objet que d'une seule adjudication. Une exception à cette règle serait possible dans les quelques jours précédant une réouverture afin de bénéficier des distorsions qui ne manqueront pas de se manifester.

L'obligation de la part des investisseurs de divulguer leurs positions globales dans les titres sous adjudication du gouvernement canadien nous apparaît, d'une part, excessive et, d'autre part, elle est la conséquence d'une réglementation susceptible d'apporter des distorsions dans les marchés (calcul des limites de soumissions sous réserve des positions acheteur et vendeur nettes). Compte tenu des solutions de rechange (le marché "w.i." entre autres), l'avantage de participer aux adjudications, bien que réel, n'est probablement pas suffisamment important pour qu'un investisseur de notre nature établisse des règles de régie interne visant à respecter les diverses directives de divulgation que la Banque du Canada désire imposer. De plus, nous réagissons avec surprise et étonnement à la présence de mesures de rétorsions qui pourraient être appliquées à l'encontre d'investisseurs par l'agent financier du gouvernement canadien advenant le non-respect des règles de divulgation. À titre d'investisseur, nous n'avons pas été habitués dans le passé à ce que des émetteurs évoquent des représailles éventuelles, et ce, avant même une émission!

L'objectif poursuivi par la Banque du Canada peut être atteint par d'autres moyens. Nous croyons qu'une diminution significative des risques d'appropriation (ou tout au moins leurs conséquences) pourrait être réalisée si un assouplissement des règles de livraison d'obligations reconstituées était permis par CDS. Ainsi, un mainteneur de marché ayant un engagement de livrer un titre faisant l'objet d'une appropriation pourrait reconstituer le titre sur le marché des coupons et présenter ce titre reconstitué à la livraison, ce titre étant dorénavant reconnu par CDS comme étant de bonne livraison. Grâce à l'initiative de la Banque du Canada de concentrer les dates de paiements d'intérêt, de telles modifications aux règles de livraison pourraient ultimement accroître de façon significative les risques encourus par un intervenant désirant s'approprier une émission lors d'une adjudication. De telles modifications auraient également l'avantage de s'attaquer aux opérations d'appropriation dans le marché secondaire. N'oublions pas que ce qui fait l'objet de

transactions est une suite de promesses de payer du gouvernement canadien. La valeur de ces promesses de payer demeure la même quelle que soit leur provenance. Les modes de livraison actuels font que ces promesses de payer peuvent avoir des valeurs différentes selon le véhicule utilisé pour les transiger.

Nous pensons également que la Banque du Canada, dans son rôle d'agent financier du gouvernement canadien, pourrait à l'occasion manifester un comportement opportuniste lors de situations d'appropriation. Dans l'éventualité où des distorsions importantes seraient observées à la suite d'opérations d'appropriation, la Banque du Canada pourrait de façon opportuniste émettre au nom du gouvernement canadien, et ce à brève échéance, les mêmes titres faisant l'objet de l'appropriation. Nous croyons que de telles interventions dans les marchés ne seraient probablement requises que de façon exceptionnelle en raison de leur caractère dissuasif.

Une gamme importante d'échéances est couramment disponible dans le marché monétaire. Un regroupement d'échéances pourrait également être souhaitable afin, d'une part, d'augmenter la taille des encours pour une échéance donnée et, d'autre part, de permettre grâce à des réouvertures de corriger des distorsions résultant d'appropriations. Ainsi, plusieurs émissions consécutives de bons du trésor pourraient partager la même date d'échéance.

Il va sans dire qu'une telle façon de procéder de la part du gouvernement canadien modifierait à terme la gestion de sa dette. Nous pensons toutefois que la disponibilité des instruments de gestion de dette est suffisamment importante pour permettre à la Banque du Canada de remplir pleinement son mandat à l'égard du gouvernement canadien dans le cadre du nouvel environnement qui résulterait de ces modifications.

La Banque de Canada, par son projet de modification, désire apporter des correctifs à un problème réel de marché. Nous croyons qu'une solution à un problème de marché ne peut provenir d'une réglementation additionnelle. Une réglementation ne peut rétablir qu'un équilibre artificiel et instable entre les quantités offertes et les quantités demandées. Un encadrement strict et une réglementation sévère des marchés, bien que désirables *prima facie*, ne peuvent engendrer une allocation plus efficace des ressources financières et de l'épargne. Au contraire, nous pensons qu'une plus grande efficacité des marchés ne sera possible que si on favorise une plus grande flexibilité du fonctionnement des marchés obligataire et monétaire canadiens.

Nous vous remercions de l'opportunité que vous nous avez offerte de commenter le projet de modification des règles régissant les adjudications de titres du gouvernement canadien. Nous espérons que nos commentaires aideront la Banque du Canada à isoler les initiatives susceptibles d'augmenter de façon durable l'efficacité et la profondeur des marchés financiers canadiens. Nous vous prions d'accepter l'expression de nos sentiments les meilleurs.

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Unattributed / Auteur désirant garder l'anonymat**Re: Government of Canada Bond and Bill Auctions**

Thank you for sending us a copy of the Discussion Paper on Bond and Bill Auctions. Our Corporation is trustee and investment manager for over \$4 billion in pension assets. Our Corporation also manages an additional \$2.5 billion in assets. Of the approximately \$5 billion in fixed income assets under management over half are Government of Canada securities. Any significant changes to the auction process could have an impact on how the fixed income portfolios are managed.

The Corporation is very active in the Government of Canada bond market, but has rarely participated in the "when issued" market. We have been concerned about the potential for excessive manipulation and the lack of transparency in the marketplace. As a result, the Corporation is very supportive of the initiative to improve the auction process.

We also believe that the restricted transparency of bond prices and flows is an impediment to the efficiency of the Canadian bond market. We have eagerly awaited the arrival of CANPX for several years. Although we appreciate some of the difficulties in implementing CANPX, we believe that these obstacles must be overcome as soon as possible. We look forward to any support you can lend with regards to improving the transparency of the Canadian bond market.

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I welcome the attention you are giving to bond / repo trading, and the adverse consequences produced when those markets are manipulated. I agree that the integrity of the Canadian financial markets must be protected.

I worry about large, aggressive repo players which have enough funds available to squeeze GOC bond issues for the benefit of their repo trading desk. Their power to manipulate the repo market is enhanced when GOC bond issues are small. These players must prefer new issues over reissues, as bond issues would remain small enough to manipulate. Personally, I am concerned when I observe two GOC bond issues maturing at the same time, as I believe larger issue sizes would provide smaller players with more protection.

I would suggest the Bank of Canada maintain two bond maturity dates each year (March and September or June & December) to ensure issue sizes remain sufficiently large to maintain liquidity.

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