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May 5, 2005

SHORCAN's Response to OSC Concept Paper 23-402

Introduction:

Shorcan Brokers Limited ("Shorcan") is pleased to provide its comments on the issues and responses to the questions raised in OSC Concept Paper 23-402 entitled "Best Execution and Soft Dollar Arrangements". Shorcan wishes to commend the Ontario Securities Commission ("OSC") for inviting comment on the "best execution" concept which raises the issue of what is the appropriate market structure and level of regulatory oversight most conducive to achieving market policy goals such as efficiency, price discovery, liquidity and best execution.

About Shorcan:

Shorcan is an active participant in the Canadian fixed income marketplace, is registered as a limited market dealer under the Securities Act (Ontario) ("OSA"), operates as an inter-dealer bond broker ("IDB") and has been recognized by the Investment Dealers Association of Canada ("IDA") as an Approved IDB under IDA Regulation 2100. Shorcan has been in the wholesale bond business in Canada for 28 years providing a neutral and anonymous "hybrid" trading venue for domestic and foreign banks and dealers trading Canadian government bonds to manage their inventory risk. Shorcan's system is a hybrid in that it combines electronic trading features and traditional "voice broking". The wholesale fixed income marketplace has a telephonic dealer-to-customer segment and an inter-dealer ("IDB") segment. The Canadian IDB market represents roughly 40% of daily trading in the Canadian fixed income market as measured by dollar value. The principals of Shorcan are well known participants in IDB fixed income markets and have been keenly interested in all regulatory developments since the 1980's affecting both trading and bond market structure.

Shorcan's interest in equity markets has developed more recently. Over the past six months, Shorcan has been working with Mr. Joie P. Watts to explore and identify potential business opportunities for Shorcan in the equity trading area. Mr. Watts has 28 years of experience in institutional and retail equity markets and trading, most recently as CEO of Instinet Canada Limited. He is very familiar with equity market structure, electronic trading and equity derivatives and has been principally responsible for this comment.

General:

The frame of reference of these comments is : (1) the objectives of National Instrument (NI 21-101) which came into effect in December 2001, and (2) the definition of "best execution" proposed by the Association for Investment

Management and Research (AIMR) Trade Management Guidelines (2002). AIMR recently changed its name to the "CFA Institute".

The objective of NI 21-101 is to encourage the development of multiple marketplaces as well as competition between marketplaces in Canada. It was envisioned that multiple marketplaces would evolve to serve specialized needs and compete for order flow in Canadian equities. Although it has taken years for marketplace concepts to be translated into live businesses, a number of marketplace ideas are about to become functioning marketplaces. The reason that multiple marketplaces can spring up has to do with the "best execution" concept itself.

In the AIMR Trade Management Guidelines (2002), the CFA Institute defines Best Execution as "*the trading process Firms apply that seeks to maximize the value of a client's portfolio within the client's stated investment objectives and constraints*".[1] The Guidelines go on to suggest that "*determining the quality of trade executions entails the evaluation of subjective, objective and complex qualitative and quantitative factors*".[2] The Guidelines also contain the following commentary:

"*This definition recognizes that Best Execution:*

- *Is intrinsically tied to portfolio-decision value and cannot be evaluated independently,*

[1] AIMR Trade Management Guidelines (2002) at p.3
[2] AIMR Trade Management Guidelines (2002) at p.2

- *Is a prospective, statistical, and qualitative concept that cannot be known with certainty ex ante,*
- *Has aspects that may be measured and analyzed over time on an ex post basis, even though such measurement on a trade by trade basis may not be meaningful in isolation, and*
- *Is interwoven into complicated, repetitive, and continuing practices and relationships."*[3]

Regulation must avoid the trap of creating trading rules that interpret "best execution" too narrowly. The definition quoted above recognizes that "best execution" is multi-dimensional and should not be confused with "best price". For institutional investors and dealers, "size" and other variables impose significant, recurring constraints. "Best execution" and "best price" can be dramatically different things. Shorcan suggests that regulation which withdraws criteria for competition needs to be considered with caution.

Questions:

(1) Are there any changes to current requirements that would be helpful to ensuring best execution? Do you think that clients are aware of their role in best execution or would some form of investor education be helpful?

[3] AIMR Trade Management Guidelines (2002) at p.3

In principle, Shorcan is comfortable with the CFA Institute's description of best execution "as a process with a goal of minimizing overall portfolio transaction costs and maximizing portfolio objectives". This approach recognizes that the relative importance of specific parameters associated with execution quality can vary according to the specific needs of the individual investor or trader. The importance of "price, size, cost, speed and certainty" and how they interact with each other is both investor specific and situation specific.

Another critical consideration is that "best execution" obligations apply to "market participants" such as dealers trading on an agency basis but not to marketplaces. Under the CSA's National Instrument 21-101 on marketplace operation, "best execution" obligations are explicitly made inapplicable to "marketplaces" in Section 6.11. Institutional investors trading on behalf of their underlying clients have similar "best execution" obligations under the CFA Institute Guidelines. Shorcan agrees that "market participants" should be allowed to choose the marketplace that is most conducive to meeting their investment objectives, which, in the context of this discussion, includes the goal of "minimizing overall transaction cost".

As to the second part of question one, Shorcan believes that institutional clients and the vast majority of individual clients have a clear understanding of their role in achieving best execution.

(2) Should there be more prescriptive rules than those that currently exist for best execution or should the methods for meeting best execution be left to the discretion of registrants?

As suggested in question one, rules on best execution should be general guidelines and recognize that best execution is a process. Detailed rules are undesirable because “best execution” is unique to the specific investor or trader and the context of a particular trade. Best execution is situational. It has to be tied to the needs, objectives and constraints of the particular client or underlying portfolio.

For the client using an agent, best execution flows from the specific broker-dealer relationship. The broker acting on behalf of the client has a fiduciary obligation to execute according to the specific instructions given by the client.

Shorcan believes that the current rules for best execution do not require further significant elaboration. Section 5.1 and section 5.2 of the Universal Market Integrity Rules (“UMIR”) which cover a dealer’s fiduciary responsibility and best price obligation when acting as agent, together with By-Law 29 of the Investment Dealers Association of Canada (IDA) which codifies the standards of conduct and ethics expected of a member when transacting business, are sufficient. The danger of making the rules more prescriptive is that the regulator would run the risk of imposing obligations on participants that might not be universally relevant to all participants, their clients or the specifics of the trade. A large part of the process is subjective and qualitative.

(3) Do you believe that there are other elements of best execution that should be considered? If so, please describe them.

The main elements of best execution put forward in the OSC Concept Paper, namely price, speed of execution, certainty of execution and total transaction costs are a good starting point. The Paper also breaks down "total transaction costs" into cost of execution, market impact and opportunity cost. However, in the context of equity markets (relative to fixed income markets), exchange trading rules have almost exclusively focused on price alone as being the most important element of best execution. This emphasis, at first glance, appears to be reasonable since sellers should receive the most they can and buyers pay the least they can in an efficient market but the importance of this focus is overblown and can be misleading. It is also based on an erroneous assumption that price priority protection is the most important aspect of best execution and needs to be mandated. The natural forces of competition and arbitrage between participants and marketplaces and the rational behaviour and economic self-interest of traders and investors will ensure that "trade-throughs" are minimized. In Shorcan's view, the occasional trade-through is a small price to pay relative to the additional costs associated with over-regulation of our capital markets.

Shorcan suggests that, in the context of equity markets, the pendulum has swung too far in favour of best execution concepts that may be appropriate for the small investor but have hurt the institutional investor for whom the interaction of large order size, market impact and information leakage increase overall transaction costs and depress portfolio returns. Ironically, this result ultimately hurts individual investors whose money and retirement savings are being managed by institutional investors such as mutual funds, pension plans, investment counselors and hedge funds. It is also important to note that, if market rules limit institutional trading, the net effect on the whole market, including the retail investor, is reduced liquidity.

It is appropriate for market regulators to address the unique needs and constraints facing institutional investors and large traders who are inhibited in their ability to execute large size orders by the lack of choices available in the Canadian marketplace. Encouraging greater competition and innovation between marketplaces will result in more specialized solutions to serving differing needs that will ultimately lead to more robust and deeper pools of liquidity for Canadian equities.

(4) If audit trail information is not in easily- accessible electronic form, how is the information used to measure execution quality? Is there other information that provides useful measurement?

From the outset, Shorcan's contention has been that "execution quality" is multi-faceted and encompasses both qualitative and quantitative variables based on the goals, objectives and constraints of the specific investor. It's an assessment process that is highly situation specific and entails an evaluation of both subjective and objective factors.

Responding to the question, the most visible, objective elements of execution quality such as time of trade, execution price and quantity should all be disseminated in "real-time" electronic form. This concrete information can be compared to the original time-stamped order and market levels that prevailed at the time that the order was received. It is Shorcan's opinion that the relevance of "real time post-trade transparency" to measuring execution quality cannot be understated. This electronic trail of quantity and price for executed trades is likely the most powerful tool available to traders, investors and regulators for assessing "execution quality" of brokers and other market participants. When brokers compete for client order flow, they are subject to reputation risk for every agency trade they do. Given that brokers "live or die" based on their clients' ongoing assessment of their execution service, reputation risk is something that is taken very seriously.

(5) Do you believe the suggested description emphasizing the process to seek the best net result for a client is appropriate and provides sufficient clarity and, if not, can you suggest an alternative description?

Yes. It should be obvious that the regulator's role should not be to unilaterally impose a standard definition that applies universally to all participants.

(6) Do you believe that there are any significant issues impacting the quality of execution for: (a) Listed equities – whether Canadian-only, inter-listed or foreign-only; (b) Unlisted equity securities; (c) Derivatives; or (d) Debt securities?

Shorcan believes that the most significant issues impacting execution quality for listed equities are: (1) depth in liquidity, (2) trading rules that serve to constrain the free flow of capital between competing marketplaces, and (3) the pre-disposition of "self-regulatory organizations" to preserve the "status quo" either by conscious effort due to their basic structure or, unwittingly, due to the creation of excessive or unnecessary rules (i.e. over-regulation) which inhibits competition, creativity and innovation. A brief discussion on each of these follows below.

In a recent Shorcan Power point presentation, one of the slides looked at the relative trading velocity for NASDAQ, NYSE and TSX where trading velocity refers to the percentage of total market cap that turns over in a year[4]. For

[4] See attached Exhibit 1 from Shorcan Equity: Presentation to OSC Staff (February 7, 2005)

the year 2004, NASDAQ traded 248% of the overall market capitalization of its underlying stocks, NYSE 91% and TSX only 58%.

Trading velocity is generally acknowledged to be a highly important indicator of depth of liquidity and market quality. [5] Turnover has a high positive correlation to tightness of the bid-ask spread which is a significant component of market quality. Other things being equal, transaction costs are lower and liquidity is higher in marketplaces where spreads are tighter and where there is more capital committed to trading. This relationship is vividly demonstrated in the Canada bond market, and the U.S. treasury market, where spreads are razor-thin, and trading is dominated by well-capitalized dealers, banks, and, institutional investors. In 2004, the outstanding value of Government of Canada bonds and U.S treasuries had annual turnover of a whopping 15.2 and 32.2 times respectively.[6] It is Shorcan's contention that a significant part of the explanation for the much lower turnover and lesser liquidity in TSX stocks is the absence of competing execution venues that exist for NASDAQ securities such as ARCAEX, INET and SuperMontage as well as the lack of an IDB marketplace (an inter-dealer broker market) where dealers can more efficiently manage their trading risks. Regulation that encourages more competition and specialization in TSX equities would improve the liquidity of the Canadian marketplace as a whole.

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[5] See for example, *The Evolution of Liquidity in the Market for Government of Canada Bonds* and *Canada's Capital Markets: How Do They Measure Up?* In Bank of Canada Review (Summer 2004)
[6] See attached Exhibit 2 from Shorcan Equity: Presentation to OSC Staff (February 7, 2005)

The strength and integrity of North America's equity markets depends most on the basic principle that a broker acting as agent has a fiduciary obligation to seek "best execution" and represent his client's interest ahead of his own. This is a simple but extremely powerful and effective rule for policing market participants. When the regulatory authorities impose harsh penalties on brokers who violate this principle, it acts as a strong deterrent to such behaviour and enhances public confidence in the marketplace.

Unfortunately, there are other rules, for example, the "trade-through" rule, which can have negative consequences that include restricting free market competition and over-regulation that stifles innovation. Regulators both in the United States and Canada are currently in the midst of debate on the issue of "trade-through". South of the border, the SEC narrowly passed by a three to two vote on Wednesday, April 6th, Regulation National Market System (NMS) which will impose the NYSE's "trade-through" rule upon the NASDAQ marketplace. The SEC's decision is not expected to be implemented until mid-2006.[7] Proponents and opponents to the "trade-through" legislation will continue to heatedly argue the merits of the rule. For example, Louisiana Republican Rep. Richard Baker, chairman of the House of Representatives Capital Market Subcommittee, said he might introduce legislation to undo what he described as "*a horrible step toward making our free market system substantially less free*".[8] SEC Commissioner Cynthia Glassman who voted against Reg NMS called the measure "*a massive*

[7] See *Update 1 –SEC Vote Spares NYSE Market Structure,* Reuters News (April 6, 2005)
[8] ibid

intrusion" into the markets. [9] In Canada, within days of the controversial passing of Reg NMS in the United States, Market Regulation Services published RS Notice 2005-02 entitled "Commitment to Neutral Trade-Through Protection". It appears that one of the goals of RS in moving so quickly is to push through "trade- through" amendments to the Universal Market Integrity Rules (UMIR) and pre-empt the possibility of any additional reasonable debate on the matter. Shorcan suggests that more discussion and analysis should be undertaken to understand the potential consequences of this unusual RS decision.

Shorcan thinks that there is no need to make changes to the current "trade-through" obligations in UMIR to impose burdens on "access persons" that they do not currently have. Economic self-interest and the rational behaviour of participants is enough to ensure that actual trade-throughs will be the exception.

(7) How should dealers in Canada monitor and measure the quality of executions received from foreign executing brokers?

When a Canadian broker gives an agency order to a foreign broker for execution, the quality of execution should be assessed applying the same principles that the Canadian dealer would be "held to" by the client if the Canadian broker had executed directly. It should be the responsibility of the

[9] See *Stock Market Overhaul Clears Divided SEC* ,Reuters News (April 6, 2005)

Canadian broker to assess and monitor the execution quality of the foreign executing broker always from the perspective of the fiduciary obligation owed to the underlying client.

(8) Do you think that internalization of orders represents an impediment to obtaining best execution?

No. Existing IDA regulation related to “fiduciary responsibility and the general obligation to deal honestly and fairly with clients” and Part 5 and 8 of UMIR adequately protect clients’ interest. It is fair for dealers to internalize client order flow as long as their agency obligations for “best execution” are honoured. Also, it should be noted that dealers are able to package prices together across multiple markets and the net result is better service and better executions for the clients.

Also, it is important to note that the Toronto Stock Exchange (TSX) has in place its own exchange-specific rules such as the order exposure rule which requires a “participating organization” to expose client orders under 1200 shares to the TSX Book. Also, the customer-principal trading rule (section 6.3 of UMIR) does not allow a dealer to cross a client order of 5000 shares or less as principal without price improvement unless the best bid-best offer spread is already the minimum increment. These rules were put in place as a result of recommendations made in the TSE Special Committee Report “Market Fragmentation: Responding to the Challenge” (published in 1996).

Contrary to public perception, the TSX marketplace is not a pure auction marketplace based on "time priority at a price". The above rules together with the TSX crossing rules continue to afford a participating organization considerable latitude to internalize its own client order flow. The "institutional upstairs" market for block trading represents approximately 50 to 60% of daily TSX trading value and clearly demonstrates that the TSX operates a hybrid "two-tier" marketplace that has a different set of rules for institutional and retail orders. Retail orders have limited capability to interact with institutional orders in the TSX "upstairs marketplace". This result demonstrates that the TSX understands that its constituents have different, specialized needs that require different, specialized trading rules. Fragmentation arguments put forth by the TSX or any other exchange to inhibit new marketplace competition should be viewed cautiously by the regulators in light of the TSX's own structure. The TSX is a fragmented marketplace and fragmentation is not necessarily a bad thing. Specialization in markets is what leads to competition, innovation and more investor choice.

(9) Should there be requirements for dealers and advisors to obtain multiple quotes for OTC securities? Should there be a mark-up rule that would prohibit dealers from selling securities at an excessive mark-up from their acquisition cost (similar to National Association of Securities Dealers, Inc. (NASD) requirements dealing with fair prices)?

Shorcan believes that it is not necessary to make this a mandatory regulation. Dealers and advisors are already expected to perform appropriate due diligence in seeking best execution for clients under existing rules. Further, clients expect dealers and advisors to exercise "best judgment". For example, in a fast moving market when liquidity is most urgent, requiring a dealer to seek out multiple quotes could actually cost the underlying client in the sense of missed "best execution" opportunities.

With reference to a "mark up" rule, Canada is a country that benefits from a free market system. As such, there is no justification to formally mandate a cap on how much a dealer is allowed to make in profit. It is important to understand how an appropriate mark up would be determined given that price is a function of risk. The volatility of any one stock is dynamic and an "appropriate" mark up must move in conjunction with such volatility. If the marketplace is not a monopoly, participants, access persons and customers are not obligated to trade at prices they don't like. No one is "holding a gun to their head". Competition between dealers and between marketplaces will tighten spreads naturally. There is existing regulation to punish any collusion on the part of dealers acting in concert to "fix prices".

(10) How is best execution tracked and demonstrated in a dealer market that does not have pre- or post-trade transparency such as the debt or unlisted equity market?

The simple answer is: by the participants in such a market as best they can. Given the state of technology today and the fact that dealers in securities need to be registered with a securities commission in Canada, Shorcan's assumption is that the regulator and the investor, at a minimum, will have access to real time post-trade transparency in all markets. This information must be time, price and quantity specific.

Conclusions:

It is Shorcan's perception that, after a considerable gestation period, there is currently the potential for new competition from a number of sources to emerge in Canada. We assume that securities regulators themselves have been waiting for just such a result. In Shorcan's view, it is critical that rules pertaining to "best execution" be clear enough for regulators to intervene and "regulate" where necessary but also broad enough to reflect the relative importance of the various factors that define the concept to a specific investor and situation. The "trade through" issue is a perfect example where imposing a "best execution" obligation on participants' trading as agent rather than a "best price" obligation will allow "market forces" to achieve the desired result.

Shorcan has not responded to the particular questions in the Concept Paper related to "soft dollar arrangements". Shorcan's general attitude to soft dollars, commission recapture and directed brokerage is that these practices should be allowed as long as “best execution” obligations are respected and as long as the details of such arrangements are fully transparent and “in the public domain”. This enables investors, traders and other stakeholders to make intelligent decisions regarding their choice of broker and execution venue. In essence, how a market participant packages and differentiates its particular “value added” proposition to its customers is exactly the competition that makes the marketplace more efficient and robust.

REFERENCE MATERIAL

(1) AIMR Trade Management Guidelines (2002) published by Association for Investment Management and Research

(2) Bank of Canada Review – Summer 2004

(3) Equity Markets in Action – The Fundamentals of Liquidity, Market Structure & Trading (2004) by Robert A. Schwartz and Reto Francioni published by John Wiley & Sons, Inc.

(4) National Instrument 21-101 Marketplace Operation (NI 21-101)

(5) National Instrument 23-101 Trading Rules (NI 23-101)

(6) OSC Rule 23-501 Designation as Market Participant

(7) RS Notice 2005-02 – Commitment to Neutral Trade Through Protection (April 8, 2005)

(8) RS Market Integrity Notice – Request for Comments – Provisions Respecting "Off-Marketplace" Trades – No.2004-18 (August 20, 2004)

(9) " A Review of Front Running and Client Priority Issues in Canadian Equity Marketplaces" by Market Regulation Services (RS) (March 31,2005)

(10) Shorcan Equity – Presentation to Ontario Securities Commission Staff (PowerPoint -February 7, 2005)

(11) "U.S. House Panel to Hear SEC Chief on Stock Markets" (Reuters News-Monday, March 14, 2005)

(12) "Lawmaker Slams Part of U.S. SEC Market Overhaul Plan" (Reuters News-Tuesday, March 15,2005)

(13) "SEC Heads for April Showdown on Markets Overhaul" (Reuters News-Thursday, March 17,2005)

(14) "Stock Market Overhaul Clears Divided SEC" (Reuters News-Wednesday, April 6, 2005)

(15) "Update 1- SEC Vote Spares NYSE Market Structure" (Reuters News-Wednesday, April 6, 2005)

(16) Speaking Notes for Tom Atkinson – "Dialogue With the OSC" Conference (Monday, November 1, 2004)

(17) "The Growth in Equity Market Size and Trading Activity-An International Study" by Kai Li, Graduate School of Business, UBC (March 2005)

(18) TSE Special Committee Report, Market Fragmentation: Responding to the Challenge (1996)

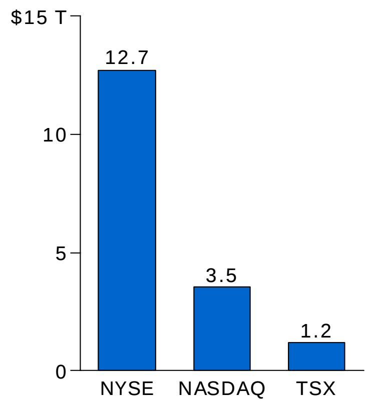
(19) TSX/RS Best Execution Conference (Handout Material) sponsored by CFIE (Canadian Foundation for Investor Education) (February 10, 2005)

(20) Universal Market Integrity Rules (UMIR) administered by Market Regulation Services (RS)

TSX stocks turn over at a lower rate than either NYSE or NASDAQ stocks

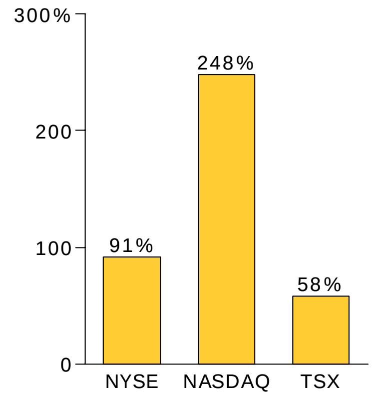
USD

Market capitalization YE2004



	NYSE	NASDAQ	TSX
Daily dollar volume	$46.1B	$34.8B	$2.6B

2004 trading velocity



	NYSE	NASDAQ	TSX
Daily turnover of total market capitalization	0.36%	0.98%	0.22%

Source: World Federation of Exchanges
Note: Trading velocity refers to the % of total market cap that turns over in a year

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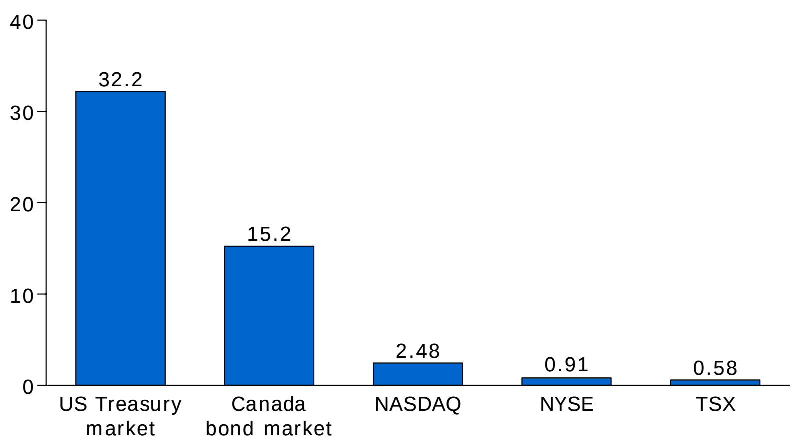
Relative size of annual trading velocity

USD

Annual velocity of trading 2004



	US Treasury market	Canada bond market	NASDAQ	NYSE	TSX
turnover annual	$125.0 T	$5.3 T	$8.7 T	$11.6 T	$0.7 T

Source: Bank of Canada; World Federation of Exchanges; Federal Reserve Bank of New York

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the next trade