NVESTMENT DEALERS
ASSOCIATION OF CANADA

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**Re: IDA Comments on Concept Paper 23-402 - Best Execution and Soft Dollar Arrangements**

I am pleased to provide, on behalf of the Investment Dealers Association of Canada (IDA), our responses to the questions raised in Concept Paper 23-402 - Best Execution and Soft Dollar Arrangements (Concept Paper). To assist you in your work, we are providing both general comments and specific responses to the questions raised in the Concept Paper.

**GENERAL COMMENTS**

The IDA is supportive of the efforts being made to better understand issues surrounding best execution and to ensure that there is an appropriate regulatory framework in place to support it. The IDA welcomes the Concept Paper's explicit recognition that over the counter (OTC) markets, and fixed income markets in particular, are distinct from exchange-traded markets and require separate consideration in the discussion of best execution and soft dollar practices.

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On the topic of soft dollar arrangements, the IDA embraces the need for clearer guidelines and industry standards for such arrangements. Soft dollars are clients' assets and should only be used to pay for goods or services that benefit the client. Greater clarity as to what does or does not fall within the "investment decision-making services" and "order execution services" categories, as set out under Ontario Securities Commission Policy 1.9 (OSC Policy 1.9), would be extremely useful. Full, true and plain disclosure, in addition to presenting the information so that clients understand the practice of these types of arrangements, is needed. The IDA agrees that more disclosure with respect to these types of arrangements for both retail and institutional clients should be an industry standard.

RESPONSES TO CONCEPT PAPER QUESTIONS

*Question* 1: *Are there any changes to current requirements that would be helpful in 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?*

IDA By-law 29.1 requires Members to observe high standards of ethics and conduct in the transaction of their business and prohibits any business conduct or practice which is unbecoming or detrimental to the public interest. The section does not specifically refer to best execution. The IDA is currently in the process of amending Policy No. 5 - Code of Conduct for IDA Member Firms Trading in Domestic Debt Markets as well as creating Policy No. 5B - Code of Conduct for IDA Member Firms Trading in Retail Debt Markets. The latter policy is to be specific to the retail debt markets and will specify that Members shall act fairly, honestly and in good faith when marketing, entering into, executing and administering trades.

Investors in the equity markets (versus the fixed income markets) more easily understand application of the current requirements for best execution. In fixed income markets, application of the best execution concept is broad and very often a function of the role the investor is playing in the trade. Fixed income clients (both institutional and retail) may be unsure of their roles and responsibilities with respect to best execution. As such, the IDA is of the view that investors would benefit from more information about their role with respect to best execution. Given the complexity of the financial marketplace and the multitude of products and services, clients need access to useful, timely and regular information presented in plain language, which informs them of their adviser's obligation as well as their own obligations with respect to best execution and in general. The IDA supports the initiative to better inform investors to help them understand issues such as best execution.

*Question* 2: *Should there be more prescriptive rules than those which currently exist for best execution or should the methods for meeting the best execution obligation be left to the discretion of registrants?*

The IDA does not support more prescriptive best execution rules. Best execution should be viewed in the context of the client and the clients' intentions. Best price may be the most important element for retail clients, but with consent, dealers may be able to focus on the other

elements while trying to achieve best execution without running afoul of the trading rules. What is best for a buyer may be different from that for a seller, an active manager may have different execution issues than an index fund managers and institutional clients have different focuses than retail clients, as institutional clients usually dictate the form of best execution that is best for them.

The United States' Securities and Exchange Commission (SEC) has stated that the duty of best execution requires a broker-dealer to seek the most favourable terms reasonably available under the circumstances for a customer transaction. Likewise, the National Association of Securities Dealers (NASD) requires members to use reasonable diligence to ascertain the best inter-dealer market for a security and to execute in such market so that the price to the customer is as favourable as possible under prevailing market conditions.

The IDA is of the view that dealers should have in place internal policies and procedures that are consistent with the general provisions that currently exist with respect to best execution. This would allow dealers to determine whether they are meeting their best execution obligation by comparing actual trade execution performance to internal best execution benchmarks.

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

The IDA believes that there are many factors that are relevant in assessing best execution in any particular circumstance. In addition to the elements listed in the Concept Paper, the IDA believes that settlement issues should also be considered. Specifically, issues such as cost of settlement, settlement credit and length of settlement period, especially where multiple parties are involved, need to be explored.

*Question* 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?*

It is possible to test execution quality based on information not maintained in electronic form (like timestamps on order tickets). The real issue is transparency of markets and quotes. Can the dealer test a specific execution without having access to full information about the state of the markets at the time of execution? There is a difference between the duty in each instance to seek best execution and the duty to ensure that that is being done. The latter is a supervision / monitoring function and doesn't necessarily imply the ability to pick a trade at random and determine that it got the best execution possible. That is possible in some markets, generally listed markets, but is becoming less certain with the advent of alternative trading systems (AIS). In other cases it is possible after the fact to compare multiple executions against market information and reach a reasonable conclusion that one's executions are (or are not) generally within the context of the existing market.

*Question* 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?*

The IDA supports the description provided in the Concept Paper that best execution is the best net result for the client. However, clarification of the meaning of the phrase "best net result" should be provided. It would also be beneficial to include some guidance that emphasizes that whether a Member has exercised reasonable diligence to obtain best execution involves a facts and circumstances analysis. Actions taken in one instance to satisfy a firm's best execution obligation may not satisfy that obligation under another set of circumstances. All parties involved in the trade, particularly the advisers and the dealer, must be able to demonstrate that they have a "process" in place that is designed to achieve the "best net result" for the client.

The United Kingdom's Financial Services Authority (FSA) takes a similar approach. In their Consultation Paper 154 on Best Execution (CP 154) they state that best execution should be seen more as the result of an investment decision-making process than a search for the best price. Price alone cannot reflect all the requirements of a customer order and that it is the overall net result to the customer that counts.

The United States Securities Exchange Act Release No. 34-23170 reiterates this notion by stating that the determining factor in assessing whether a money manager has obtain best execution is not the lowest possible commission cost but whether the transaction represents the best quality execution for the account.

The difficulty that exists is how compliance with the process is evidenced? It would be impractical that every trade be separately documented with respect to the process that was followed. It is the Member who is in the best position to determine whether their decisions on when, where and how to trade, and the executions they obtain, delivers the right results for their clients. The FSA also takes this approach in CP 154 and states that it is more appropriate to do a sampling then to monitor every transaction.

*Question* 6: *Do you believe that there are any significant issues impacting the quality of execution for the following types of securities: listed equities, unlisted equity securities, derivatives and debt securities?*

The following response is limited to the Canadian securities and derivatives markets.

The level of debt market transparency makes the measurement of best execution difficult. Buy-side clients seek quotes / prices from multiple dealers to help them determine with whom to execute. Dealers are constantly required to provide their best price points in an effort to get these executions. The recent emergence of ATS providers has improved institutional market transparency and the ability of clients to judge the quality of their executions, but problems still exist. Retail clients however are generally not in the same position vis-a.-vis transparency. In some cases they may have inadequate access to ongoing market information to judge execution

quality, and are reliant on their broker for the attributes of a trade. At the same time retail clients are generally guided by the 'buy and hold' strategy rather than the 'trading' strategy for their fixed income positions. Their need of real-time pricing information may therefore be significantly less that of an institutional investor.

With respect to listed equities, there are few significant issues impacting the quality of best execution because of the concentration of trading on the TSX and TSX Venture Exchange, where best execution is enforced under the Universal Market Integrity Rules. The same applies to listed derivatives trading on the Bourse de Montreal where best execution is enforced under the Bourse de Montreal Rules.

*Question* 7: *How should dealers in Canada monitor and measure the quality of executions receivedfrom foreign executing brokers?*

Since not all foreign jurisdictions have the same level of market transparency, it would be difficult if not impossible for Canadian dealers to monitor the quality of all executions received from foreign executing brokers. Each market is different and each trade may be different (even in the most transparent market) and as such a determination would be difficult. One suggestion would be to cross-compare the level of service of foreign dealers in the same jurisdiction and make an assessment based on that comparison. However, the IDA is of the view that it is not the role of rule-makers to decide how dealers in Canada should monitor and measure the quality of such executions and that if dealers make an honest effort to ensure execution quality that is likely sufficient.

*Question* 8: *Do you think that internalization of orders represents an impediment to obtaining best execution?*

The IDA is of the view that while there may be some situations where internalization may impede best execution there are rules to deal with such situations such as the requirement to expose smaller orders to the market. Internalization of orders is needed and does facilitate trading, particularly in large blocks, and in doing so can provide better executions then may be available in the marketplace, especially in less liquid securities. For instance, trades done with the dealer acting as agent on both sides of the transaction or trades in which the dealer acts as principal in filling a client's order could result in two identical transactions being executed at different price levels simultaneously by the same dealer but both clients may have obtained best execution from the dealer.

*Question* 9: *Should there be requirements for dealers and advisers 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 withfair prices)?*

**Multiple quote requirement**

The volume of trading on the Canadian OTC markets is relatively low and as such the markets do not receive the same attention as listed markets. Some jurisdictions require their participants to obtain a minimum number of quotes in order to determine which quote best suits the best execution needs of the client. For instance, NASD Rule 2320 generally requires dealers that execute client transactions in non-NASDAQ securities to obtain quotations from a minimum of three dealers (or all dealers if there is less then three) if there are fewer then two quotations displayed on an real time inter-dealer quotation system. The Three Quote Rule as it is known is a minimum standard, and compliance with the rule, in and of itself, does not mean a member has met its best execution obligation. The rule may be useful in transactions involving relatively illiquid securities with non-transparent prices.

The IDA is of the view that requiring dealers to obtain a minimum number of quotes for OTC securities is not necessary given the structure of the Canadian marketplace. In Canada, the OTC market in equities is minimal, and much of the market is trading in foreign non-reporting issuers, where pricing can be done off the price in the dominant market. In that case, a dealer can certainly see whether the client is getting best execution without resorting to three quotes. For junior OTC issues, there just isn't enough interest to ensure that three quotes will be available or that any quotes obtained will be reasonable. In some situations requiring multiple quotes could hamper best execution. Specifically, the time it takes to obtain prescribed multiple quotes could in some instances impede best execution. Furthermore, even when a minimum number of quotes is mandated there is no assurance that best execution will be obtained. Another consideration with prescribing a minimum number of quotes is that while one may be able to obtain the quotes, execution may not be possible in all markets. It is the dealer who has the expertise and is likely best able to decide on the market that will provide the best execution. However, the IDA believes that where dealers can readily access different markets and make a direct and immediate comparison of various quotes such a comparison should be done.

The FSA follows a similar approach in not prescribing mandatory minimum market access arrangements, as they do not feel there is a strong case for mandating a multiple quote requirement.

**Mark-up rule**

The IDA is supportive of a mark-up rule. The NASD applies a "5% Policy" to all securities traded on the OTC market. The NASD does not apply the policy to the sale of securities where a prospectus or offering circular is required. The policy looks at a variety of relevant factors in making a determination as to whether a mark-up can be justified or whether the mark-up is excessive. The IDA is supportive of a similar approach to that of the "5% Policy." However, since the IDA has never regulated fees, it might be best to require that dealers maintain and monitor compliance with internal mark-up guidelines to ensure that no mark-up is excessive.

*Question 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?*

Dealer markets are becoming more transparent and there are alternatives for a general evaluation of execution that may not be available on a trade-by-trade basis. A service currently exists to which a number of large dealers subscribe which takes trade information and compares it, letting each dealer client know whether its prices are competitive with others while not revealing the trade information received from others. This is one method in which dealers can find out if they are providing good executions.

*Question* 11: *How does an adviser ensure that its soft dollar arrangements are consistent with its general obligations to its clients?*

We require that dealers have a written agreement with the client detailing the nature of the services being provided and require the dealer to ensure that the services fall within OSC Policy 1.9.

*Question* 12: *Are there any other additional benefits or concerns with soft dollar arrangements that are not noted above?*

The Concept Paper sets out a number of arguments for and against the use of soft dollar arrangements. In addition, soft dollar arrangements give rise to other issues such as the "fairness" between clients of an investment adviser. For instance, an investment adviser may manage the portfolio for an equity fund, a balanced fund and an income fund. Most of the commissions are generated from trades for the equity fund and for the equity portion of the balanced fund are "soft dollars." These soft dollars are used to purchase general economic research that the adviser uses in its investment decision-making process. The economic research may well benefit decisions with respect to the income fund and the income portion of the balanced fund as well as the equity portion of the balanced fund despite the fact that those funds generated few or none of the soft dollars used to pay for the research.

*Question* 13: *If it is acceptable to pay for goods or services using soft dollars, which services should be included as "investment decision-making services" and "order execution services" and which services should specifically not be included?*

There are many conflicts that arise from the use of soft dollar arrangements. The SEC's reluctance to ban soft dollar arrangements seems to be driven by the fact that such arrangements pay for much of the equity research that is done outside of the large integrated securities firms. The IDA is of the view that the current requirements under OSC Policy 1.9 and Autorite des Marches Financiers Policy Statement Q-20 are vague and that the language specifying what goods and services can be paid for with commission dollars should be tightened up. Specifically the goods and services that may qualify as either "investment decision-making services" or "order execution services" under OSC Policy 1.9 are not well defined. As a result, items may

inadvertently fall within (or outside of) the boundaries of these services categories when they should not. As such, better category definitions and more guidance on what may be included and what is prohibited in each category would be prudent. This approach is consistent with the approach being taken by the FSA and the SEC who are trying to better define what does and what does not qualify.

What also is lacking, which guidance should provide, is some criterion for making the judgment as to whether or not a certain good/service qualifies as either "investment decision-making services" or "order execution services". For example, OSC Policy 1.9 would currently include costs for databases or software used to generate services such as analysis and reports concerning economic trends in the definition of investment decision-making services. However, the cost of the computer workstation needed to house the database / software is not specifically included or excluded. The IDA contends that in this example, the computer workstation should not be paid for with commission dollars and is an example of something that could be specially excluded from the goods and service category definitions. Other examples of items that should be specifically excluded include: dedicated phone lines, seminar fees, subscription for publications, travel, accommodation and entertainment costs, office equipment or ancillary facilities, membership fees to professional associations and computer hardware, all of which are in line with the position taken by the FSA.

*Question* 14: *Should there be additional disclosure requirements beyond those specified in OSC Policy* 1.9 *and AMF Policy Statement Q-20, National Instrument 81-101 and proposed in National Instrument 81-106? Should the disclosure requirements be the same for third party soft dollar payments and bundled commissions?*

Additional disclosures

The IDA supports additional general disclosures that would provide useful information to both retail and institutional clients.

Disclosure requirements for third party soft dollar arrangements and bundled commissions

The IDA is of the view that third party soft dollar payments and bundled commissions are similar enough issues to attract the same regulatory approach. Since use of both practices may yield a lack of transparency and accountability, and in turn affect client relationships, it is imperative that they be treated in a similar manner. Otherwise a situation could arise where one practice is used over the other because it receives a more favorable regulatory treatment.

*Question* 15: *What, if any, are the practical impediments to an adviser:*

*(a) splitting into their component parts commission payments that compensate for both order execution and "investment decision-making services" as a*

*result of either third party soft dollar arrangements or bundled commissions; or*

*(b) making a reasonable allocation of the cost of "investment decision-making services" to the beneficiaries of those services (for example, allocating across mutual funds)?*

(a) Impediments to splitting of commission payments

The IDA is of the view that there are no real impediments. Advisers should know the possibilities for order execution and what they cost, so they should be able to make a reasonable determination as to the cost of just executing a trade and the cost of executing one with decision-making support, just as a retail client may be able to tell the different between the commissions charged by a full service broker and those of a discount broker. The difference is the cost of the different service. Any commission splitting rules would need to speak to a fair and reasonable allocation, possibly with auditor testing. Competition might even result, if it hasn't already, in services that review trading costs at different firms and provide guidance on such allocations.

(b) Impediments to making a reasonable allocation of the cost of "investment decision-making services"

Same issue as in (a). Standard would need to require a reasonable and defensible allocation.

*Question* 16: *If the split between order execution and "investment decision-making services" cannot be measured reliably, should the entire commission be accounted for as an operating expense in the financial statements? If it can be measured reliably, should the "investment decision-making services" portion of commission payments be accounted for as an operating expense in the financial statements?*

The IDA is of the view that both order execution and investment decision-making services should be accounted for as an operating expense. Bundled commissions wouldn't have to be split and soft dollar costs would have to be included. Again the essential point is that they be treated the same to prevent perverse incentives. For example, if you include bundled commissions as an expense but not soft dollars, there is an incentive to buy outside services with soft dollars, even if they are inferior to those paid for by bundled commissions. Here again, however, it is possible that the bundled commissions for one fund will pay for research that's more used in making investment decisions for another. Unfortunately, there's no perfect way of accounting for these things. Presumably money managers are being judicious in who they pay bundled commissions to and for what types of transactions.

*Question* 17: *Would it be appropriate for the MER to be based on amounts that differ from the expenses recognized in the audited financial statements? For example, should the entire commission continue to be accounted for as an*

*acquisition/disposition cost in the financial statements but the MER calculation be adjusted either to include all commissions or to include only that portion that is estimated to relate to "investment decision-making services"?*

No comments.

*Question* 18: *Should directed brokerage or commission recapture arrangements be limited or prohibited?*

While there are pros and cons to allowing such arrangements, the IDA is of the opinion that since directed brokerage or commission recapture arrangements do not appear to be problematic in the Canadian markets at this time, these arrangements should continue. In order to maintain the integrity of the marketplace, firms that partake in such arrangements should be required to disclose to clients the existence of such arrangements in a clear and concise manner. This is consistent with the approach taken by the FSA which is to allow such arrangements to continue until such time as other developments in this area occur which could lead to changes in the use of these arrangements.

*Question* 19: *Should disclosure be required for directed brokerage or commission recapture arrangements?*

As stated in the response to question 18 above, if arrangements such as direct brokerage or commission recapture arrangements continue to exist in the marketplace, full, true and plain disclosure should be made mandatory.

*Question 20: Would any of these initiatives be helpful in Canada?*

In concept, obtaining the most favorable or advantageous terms for client orders should be similar in the United States and Canada. However, some of the rules and requirements that have emerged in each jurisdiction reflect different market structures. Consequently importing all United States style rules at this time may neither be warranted nor appropriate. As stated throughout our response, the IDA is of the view that the concepts developed in the United Kingdom represent a flexible and reasonable approach which is most consistent with the IDA's views and as such we feel they warrant further study.

Thank you for this opportunity to provide feedback on the Concept Paper.

Yours truly,

Joseph J. Oliver
President & CEO