financial executives international canada

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Dear Sir and Madam,

Re: Concept Paper 23-402 – Best Execution and Soft Dollar Arrangements

Please accept this letter as a brief response for your consideration on Concept Paper 23-402. At the outset we apologize for this late reply, as in recent months there has been a large quantity of material advanced for comment by public bodies. The following remarks are made on behalf of the Issues and Policy Advisory Committee (IPAC) of Financial Executives International Canada (FEIC) and do not necessarily represent the views of FEI Canada or its members.

Our response is premised on our member's responsibility to supervise the people who manage money as a profession within the firms with whom our members are employed. Treasury operations, pension asset management and employee savings investment management personnel, both internally employed and as contracted out to specialist firms form the major relevant activity centres which would be impacted by Concept Paper 23-402. As such, our members are aware of the standards established by the CFA Institute and as agents of change, we feel professional standards only provide minimal guidance and should be continuously improved upon wherever possible. In this regard, we welcome the dialog provided in Concept Paper 23-402.

Upon first reading this paper, one gets an impression that it has been prepared by lawyers who carried out their research using a bottom up approach to the many issues raised. Also, Concept Paper 23-402 indicates a number of market participants were consulted. In this regard, we have a feeling the research team consulted a number of conflicted parties in the securities transactions process and thereby the researchers skirted a number of basic issues, some of which we elaborate in this letter.

For example, the approach in Concept Paper 23-402 overlooks audit and internal control issues and instead appears to address many of the issues as legal concepts requiring further definition and subsequent regulation**.** We feel the law on the subject is already straight forward, but enforcement through industry self-regulation and through public agencies, such as securities authorities and stock exchanges has been deficient and modest at best.

Issues surrounding best transactions executions and soft dollar payments have persisted for a number of reasons, some of which are fueled by competing forces and evolving technology betterments within capital markets (e.g. monitoring software) and others by less than forthright market dealings.

If very few credible voices ask questions and/or scrutinize unfair commercial activities, there is little reason to think something unacceptable is, or could be taking place. Moreover, the internal audit functions within various firms who are members of self-regulatory organizations have often been un-welcomed in the area of investment management and/or investment product sales functions, as they are seen as encroaching upon an investment manager's artistic freedom to manage capital. To be fair, scarce audit resources are usually applied to potential and/or actual problems of a higher order. For example, we observe audit efforts have mainly been applied to the securities distribution process, leaving the transactions side to be disciplined by market forces. Treasury and pension asset management would fit into the latter category.

Competition tends remove excess economic rents obtained by transacting principals and/or agents and thereby provides net added value to investors and/or savers. Until recently, competition in financial services in Canada has not been at levels witnessed in other comparable countries – e.g. the UK and USA. Competition is a higher order issue than conversions on transactions costs and appears to be ignored by Concept Paper 23-402. Nevertheless, we feel many soft dollar arrangements are an impediment to fair competition.

From a historical perspective, soft dollar arrangements have generally not been questioned until transaction discounts and/or competition indirectly forced focus on commission services as a complex package of services – most of which are well described in Concept Paper 23-402. In fact the whole idea of a "soft" dollar is rather silly from an accounting point of view, as "a dollar is normally considered a dollar" and any qualification of the term dollar does not sterilize unfair investment and unfair competitive practices. Use of the term "soft" adds spin, so as to make such appear to sound legitimate and/or ethical. If soft dollar arrangements are to continue, they should be narrowly limited in scope and subject to review as to their efficacy. Our preference would be to eliminate the incidence of soft-dollars as they are prone to unfair allocations of investor resources.

The basic issues surrounding an assessment of best execution can be summarized as:

- Fairness to the individual client interest and removal of cross subsidies.
- Transparency and/or disclosure on all relevant costs and/or considerations. exchanged – both in the budgeting and the transaction and/or audit trail process.
- Objective audits on benefits and costs associated with each line of business.
- Professional investment manager and investor education on investment management costs – e.g. in terms of basis points on normally expected investment returns. Greater emphasis on the indigenous risks inherent within investment portfolios is also required.
- Transparency on the cost of adverse selection or adverse security price movement when proportionately large acquisition and/or divestment programs are being executed. This cost in many cases far exceeds the stipulated commission.
- Accounting treatment and disclosures on economic rents charged on net trades or principal transactions, such as in the bond market. The self-regulated bond dealers should not be exempt from closer scrutiny by securities authorities. Publicly available transactions records, as with stocks would provide better dealing benchmarks than those available on private inter-market and inter-firm dealing networks.
- A broad debate should be held on expensing asset acquisition and disposition charges in the period incurred. At least in this manner, trading costs will be recognized in the period incurred and subject to debate on whether portfolio value is being added, especially where high activity levels are present. High portfolio turnover, as with many mutual funds would prompt expensing these costs.
- Better measurement technology is required on fund management efficacy than is present with the current broadly available benchmark indexes and/or star ranking systems. Perhaps, a balanced scorecard approach such as that used in industry should be promoted as an improvement. Product sponsors are generally not good at providing a balanced report on their mandates.

- Economies of scale are important in the administration of "appropriate in the circumstances" executions on securities transactions.

We now turn to general answers to questions raised in Concept Paper 23-402, using the numbering system in Concept Paper 23-402.

1. Evolving betterments in computers and associated software technologies make it easier than ever before to track transaction execution efficacy and should be encouraged. Investors too have a responsibility to demand accountability on their contracted investment services and in this regard continuing education is appropriate. A quote attributable to Benjamin Graham in the 1920's comes to mind, which went … "the purchase of a common share is a singular decision; the ownership of a common share is an ongoing responsibility." Substitute the identity of most investment products for "common share" and this quote would be broadly appropriate today.

While disclosure of transactions for stocks is relatively better than that for bonds or other asset classes, it has deteriorated during the past five years with the so-called rationalization in trade venue responsibilities in Canada. For example, publicly available historical transaction records no longer indicate if stock trades on the TSX are made as principal, agent or market maker. Furthermore, trades made on ECNs are not publicly identified in publicly accessible databases of trades and quotes for publicly listed shares. The same applies to short sales, which have indicator flags in their captured trade records, and which are withheld (impugned) when such data are made publicly available. There is little rationale for not disclosing more of the book in historical equity trade and quote data files. International precedents exist for the disclosure of up to the five best bids and five best offers with their associated depths.

Public disclosure of transactions on private inter-market and inter-firm dealing networks is seriously lacking and should be available for scrutiny by external parties. This would allow external, independent parties ability to oversee the overseers, and provides much needed competition in the oversight function.

To deal with the rationale commonly put forward by the industry and the exchanges against greater trade and quote transparency (namely, competitive reasons), such data could be provided after a one to three month "cooling off" period. Also, care must be taken that unreasonable pricing does not prevent access to such data.

For cross-listed shares, "best price execution" should be based on the IBBO (international best bid and offer) and not NBBO (national best bid and offer). If a trade for a person resident in Canada on a cross-listed share is made off the listing venue in the United States or elsewhere, this should be completely disclosed to the client.

2. Execution rules should be left to registrants and which should be articulated in registration documents and serviced by securities authorities auditors, as part of their rotational industry audit programs.

3. Measurements on best execution should include a factor for adverse price movements. Software is available for quantification of part of this process. Experienced and/or professional judgment along with luck is also important, hence measurement systems only provide guidance.

4. Periodic audit work by statutory auditors and internal audit staff should be used to ensure transaction efficacy. Economies of scale are important, hence the depth and breadth of internal procedures and controls will vary by registrant, and as such afford competitive advantage to larger operating entities.

5. "Best execution" as a cost objective is only a small part of the cost of the decision to transact in a security. Use of this term in promotional literature is only appropriate were there is comprehensive detailing of costs in relation to benefits being pursued and attained. Disclosure and/or transparency along with improvements in software technology is also important. For example, the cost of investment research and net trades entail meaningful cost elements and/or issues.

6. There are far more execution issues than those listed here, all of which can be serviced through greater transparency on transactions costs. The bond and derivatives markets are notorious for their lack of transparency, mainly as the principals hide behind their veil of privacy to protect their oligopoly rents. This is a competition and transparency issue.

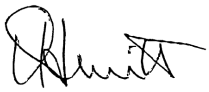
7. The technology for monitoring foreign dealers should be the same as for domestic dealers. For example New York Stock specialists require monitoring as their definition of a client interest is often at odds with that commonly understood by investors. Principal transactions should be clearly tagged as such on transaction documents.
8. Internalization of transactions orders would not normally negate the efficacy of best executions and could often be a betterment, depending on demand and supply imbalances and potential adverse transactions pressures. Judgment is often required and as such is not a problem, particularly if there is an adequate system of internal controls to mitigate possible collision. The internal audit function within a transacting institution should be monitoring transaction efficiency as a means of improving the entities overall competitiveness and added value for its clients.
9. Bracketing quotes are a recommended benchmarking procedure to monitor fairness, only where such does not signal transaction information to the marketplace. Cost related mark-up rules should only be considered if the cost of capital for carrying inventory is taken into account. In both cases, the internal audit function within a firm is in a better position monitor the client interest than a market regulator. Transparency and enhanced competition provide the best or most efficient regulation of the client interest.
10. The TSX and the participating CanDeal shareholders should be required to activate the CanDeal bond trading software system or a reasonable facsimile thereof, as the current system thwarts competition and serves to protect oligopoly rents. The TSX in Canada should be prompted move forward to also serve as a bond trading utility. The Canadian capital market is ready for a major bond exchange, which could parallel that on the New York Stock Exchange. The theme in our remarks is transparency will prompt greater competition and a more efficient allocation of resources.
11. Disclosure and possibly a client acknowledgement in the form of a waiver, along with better education on how the client's capital is processed will likely prompt investment manager to focus on the self-interest of the transacting dealer and the client.
12. In the extreme, soft dollars are an impediment to a pure focus on the client interest and should be prohibited. If they are to be tolerated, they should be restricted as to scope (e.g. to independent research only) and used with the acknowledgment of the client and fully disclosed in regular client reporting documents.
13. See answer to Question 12.
14. All soft dollar amounts should be detailed to the client in the aggregate and/or pro rated to the account of each client where technology exists to do so. Client education is also required. Relevant detail is more important than more detail per se, hence some discretion should be afforded the investment manager to make appropriate disclosures. A regulator or prescriptive rule approach should only be applied as a last resort so as to avert unnecessary costs, as there is no free lunch on more regulation. The answer is necessary regulation, where regulation is necessary. Historically, internal audit functions and/or clients have lacked the knowledge and/or courage to challenge "soft" misuses on their capital.
15. Practical impediments to an advisor are primarily related to scale of operations and the technology used to administer client accounts. Detailing of the transaction execution process and associated costs is fine, but an independent monitor, such as an internal audit department is required to service the purity of the process. Cost allocations are necessarily arbitrary, but the underlying integrity can be improved by detailing the assumptions and principles on which the allocations are being made. In the case of mutual funds, MERs are much more significant and likely excessive in relation to those in neighbouring jurisdictions. For example, the removal of foreign content restrictions on tax sheltered savings planes along with normally expected single digit investment returns will make United States savings products much more attractive to Canadians on a normally expected net return basis.
16. Accounting for transactions charges and/or commissions, as an operating expense would provide greater transparency, hence a betterment to financial reporting. However, uniformity of accounting treatment with comparable jurisdictions is important. Disclosure in the MD&A is perhaps a better process until there is universal acceptance of the accounting practice.
17. Either footnote disclosure in the financial statements or in the MD&A would be appropriate, with the MD&A being the preferred treatment until there is universal acceptance on accounting practices. Transparency on the underlying productivity of capital is the principle objective on provision of this additional information. Disclosure in normal circumstances will enhance reductions on costs and prompt internal controls for monitoring costs.
18. If "directed brokerage" and/or "commission recapture" arrangements are to be tolerated, such arrangements must entail explicit consent from each client along with disclosure of the monetary value of considerations

exchanged. For example, any transactions subject to "payment for order flow" should be clearly identified and communicated to the client. Relevant details, such as the amount of the payment and the then prevailing best bid and offer should be explicitly disclosed to the client.

19. See answer to Question 18.

We feel Concept Paper 23-402 represents a good starting point toward prompting betterments to fair dealing practices in the Canadian capital markets.

Yours sincerely



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