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BARCLAYS GLOBAL INVESTORS

May 19, 2005

British Columbia Securities Commission
Alberta Securities Commission
Manitoba Securities Commission
Ontario Securities Commission

c/o John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
Suite 1903, Box 55
Toronto, Ontario M5H 3S8
Fax: (416) 593-2318
Email: jstevenson@osc.gov.on.ca

- and -

Anne-Marie Beaudoin
Directice du secrétariat
Autorité des marchés financiers
Tour de la Bourse
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P.O. Box 246, 22nd Floor
Montreal, Québec H4Z 1G3
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Dear Sir and Madam,

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

We at Barclays Global Investors Canada Limited ("Barclays") believe that the Canadian Securities Administrators ("CSA") have taken an important step in commencing a discussion on the issues of Best Execution generally and Soft Dollar Arrangements more specifically. We thank you for your invitation to comment on Concept Paper 23-402 (the Concept Paper). We continue to strongly believe in the value of meaningful dialogue between regulators and industry participants and commend the Canadian Securities Administrators for undertaking a thorough public consultation in connection with the Concept Paper.

Barclays, which currently manages over $50 billion in assets, is one of Canada's largest and fastest growing investment managers. Barclays is part of a global investment management business that manages over one and a half trillion dollars in assets and we therefore have very broad experience in regulatory approaches applied to this industry, including trading related matters.

Barclays is now, and has throughout its history, been committed to best execution in our trading policies. As such, there are three major components to our trading philosophy: (1) An obligation to the client; (2) a commitment to best execution; and (3) ongoing trading research to accomplish this function.

We believe that a commitment to best execution requires a holistic approach to recruiting traders, adapting technology, selection of trade types and venues, use of capital commitment (Risk Trades), and the overall organization of our desk to achieve the lowest possible transaction costs for the client's objectives. Barclays has also throughout its history encouraged innovation in markets, venues, and technology, provided these endeavors do not fragment the marketplace. Our view is that the competitive effects of multiple sources of liquidity are large.

While we believe the Concept Paper asks many relevant specific questions, we believe that it's appropriate to address a concern we have with the approach commonly taken by regulators to these matters. Our specific responses, which follow the general comments below, may be better understood in the context of this more general concern.

General Comment – Institutional vs. Retail Context

There is no one definition of "best execution" that is generally recognized. "Best execution" is a complex concept that is difficult to define because there are many factors that may be relevant in assessing what constitutes best execution under particular circumstances. Securities regulators such as the SEC in the U.S., the FSA in the U.K., and the Canadian Securities Administrators and Regulation Services Inc. have tended to approach the concept of best execution from the perspective of protecting retail investors from potential self-dealing by intermediaries.

This retail consumer protection context is reflected in the belief common to many regulators that rules that prohibit "trade throughs" facilitate rather than hamper investors' ability to achieve best execution. It has led to price-based tests for execution quality where the benchmark is the highest bid price and the lowest offer price. While the inside spread is a reasonable test for retail investors with small orders it is less relevant to investors who are attempting to execute orders that are large relative to the value of the quote.

This retail focus has also resulted in rules and regulations that focus on the execution of single orders in isolation on an order-by-order basis rather than on a portfolio basis.
This single order perspective is appropriate for a broker who is executing one or several orders on behalf of a client and may be appropriate for an investment manager executing one or several orders. However, the single order focus is less appropriate for an investment manager executing a larger trade list where a portfolio context is more meaningful.

Barclays is guided in its best execution philosophy by the CFA Institute's Trade Management Guidelines. We define Best Execution to be the process of managing transactions costs through all stages of the investment cycle to ensure that the portfolio realizes its highest returns possible given

its objectives and constraints. We agree with the CFA institute's clarifying statements that best execution;

- is intrinsically tied to portfolio decision value and cannot be evaluated independently,
- is a prospective, statistical, and qualitative concept that cannot be known with certainty ex-ante, and
- 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.

Barclays defines costs to be total transactions costs as indicated by the implementation shortfall. The implementation shortfall includes visible costs such as commissions, taxes and spreads and less visible costs such as market impact, timing costs, and opportunity costs. Implementation shortfall is widely accepted as the most accurate measure of trading costs, capturing implicit as well as explicit costs. This is important since the implicit costs of a trade can be an order of magnitude greater than explicit costs, such as commissions.

Specific Responses

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?*

The current requirements in UMIR Policy 5.2 "Best Price Obligation" are too narrow. UMIR Policy 5.2 prohibits dealers from intentionally trading through a 'better' priced bid or offer on a marketplace by making a trade at an 'inferior' price on a stock exchange or other organized market. This policy applies even if the client consents to the trade at the 'inferior' price. Barclays strongly believes that it is inappropriate to apply such limitations to institutional investors. A significant amount of empirical research into the components of transaction costs and the factors that effect price has shown that price is just one element in overall execution quality. One of the most important considerations in total cost is the trade-off between market impact and timing risk. Institutional traders often need to trade off price to access liquidity to increase the likelihood of completion and reduce the risk of profitable trades getting away.

In the context of current regulations, the client's primary role in the best execution process is to give clear instructions to the dealer on how a trade is to be executed, especially concerning any factors regarding the timeliness or certainty of the execution of the order. Regulations require dealers to ensure that they have clear and complete instructions concerning the execution of the trade and that they record all of these instructions.

Given that trading is not the full-time focus of most retail clients and that the level of their knowledge of trading matters varies significantly, many of these clients may not understand their aforementioned role in best execution. However, brokers appropriately have the obligation to guide clients through the process of providing clear instructions. Traders at institutional investors should have a clear understanding of their role in their best execution process. However, their role will vary by investment manager and may be much more involved than simply providing a broker clear instructions on how to execute orders. In the execution of an institutional order, a broker who diligently follows a client's instructions should be deemed to satisfy the best execution obligation.

Investor education is a worthy objective. However, it should be left to investment management firms to ensure that the employees of the firm understand their own definitions and best execution processes.

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?*

Barclays strongly agrees that a key aspect of best execution is the obligation to act solely in the interests of our clients with the exclusive purpose of providing benefits to fund participants and beneficiaries. It is not possible for an investment manager or broker to meet any definition of best execution if their clients' welfare is not the primary consideration in creating and implementing investment decisions. It is appropriate that regulators focus on potential self-dealing by brokers and investment managers to ensure that they do not place their interests before the interests of their clients. Prescriptive rules (UMIR 4.1 Front-running, UMIR 5.3 Client Priority, UMIR 6.3 Exposure of Client Orders, etc.) that are designed to reduce potential conflicts of interest are appropriate.

Barclays believes that our fiduciary duty to maximize the value of our clients' portfolios subject to their investment objectives and constraints is of paramount importance. In keeping with our fiduciary and best execution obligations we compute transaction costs and expend considerable resources in estimating, measuring, analyzing, and ultimately controlling these costs. We do this because it is clear that implementation costs directly impact the returns that we can deliver to our clients. However, the incremental costs of any new requirements for compiling, auditing, and reporting implicit transaction costs would likely be significant. To the extent that these costs are paid out of fund assets they will have a negative impact on performance. Since portfolio transaction costs and their impact on returns are already reflected in the standardized performance information currently available to investors we do not believe that specific quantitative disclosure of portfolio transaction costs will add incremental value to the decision-making process of most investors.

There are no accepted standardized methodologies for computing market impact and opportunity costs. The assessment of execution quality is complicated by the requirement to consider and adjust for many factors such as market movements, order size, liquidity, volatility, investment strategy, trading strategy, and actual market conditions.

In accordance with the CFA Institute's Trade Management Guidelines we believe that the details of an investment manager's specific processes designed to achieve best execution should be left to the discretion of the investment manager.

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

In a discussion about best execution it is important to discuss impediments to achieving best execution. These impediments are insignificant for small orders but become significant obstacles for institutional investors who must execute larger orders that are significantly larger than the size of the best bid and offer.

Trade Through Rule:

A prohibition from trading through limit orders can be an obstacle to best execution for investment managers rather than helping to facilitate best execution.

For example, displacement requirements are not practical for portfolio trades. Investors use principal portfolio trades to receive immediate and complete execution of a trade list in exchange for a commission charge known as a bid premium. The investor accepts a certain cost and transfers all market trend and impact costs and timing risk to the broker. Investors can implement portfolio trades on a 'blind' or fully disclosed basis. In a 'blind' portfolio trade the investor attempts to control information leakage and obtain the best price for the portfolio by providing several brokers with various characteristics of the list but not the individual security names and amounts and soliciting bids from those brokers based on these characteristics. The characteristics include the value of the list by side, the liquidity profile of the list, average spread, average share price, and tracking risk. The brokers determine their bid price for the trade list based upon the characteristics of the trade list as a portfolio. The investor executes the trade with the broker who submits the best bid price and sends the broker the actual trade list that details the side, security, and order size. If the investor is not permitted to opt-out from the application of the trade through rule and brokers have to displace limit orders in the order book then the broker may not be able to 'get the trade on the tape'. This introduces additional risk for both the investor and the broker. Both the investor and the broker bear the risk of an incomplete fill such that the trade list executed could have a different risk profile than implied by the apparent characteristics of the portfolio. The potential result is that brokers will build an additional risk premium into their bid prices or may be unwilling to bid at all. This result also holds, though to a lesser extent, for fully disclosed portfolio trades. In this context, the requirement to displace limit prices acts as an impediment to best execution. Portfolio trades should be exempt from the application of the trade through rule.

Different Market Microstructures:

Barclays believes that in most cases order precedence on a marketplace should be determined by price time priority. Under normal circumstances, when trading on a marketplace it should not be possible to trade through better priced orders that are entered in the limit order book of that marketplace. If "trade throughs" of better priced orders were frequent, investors could lose confidence in the market and would not have the incentive to enter orders in the limit order book resulting in less liquid, more volatile markets and less meaningful prices. As noted above, portfolio trades should be exempt from displacement requirements.

Different marketplaces have different rules and market microstructures that make displacement obligations across multiple marketplaces impractical. For example, the TSX has an iceberg order type where there is a visible disclosed portion and an invisible undisclosed portion of the order. If the visible portion of the order executes, a portion of the balance of the order automatically is displayed. The undisclosed portion of the order has price but not time priority. The visible portion of an iceberg order has time priority established at the time the visible portion of the order is displayed. In the context of multiple marketplaces, iceberg order types and trade through prohibitions imply that displacement requirements cannot be known with certainty. Operationally this means that traders must take the time to displace visible and invisible orders before trading the desired volume on another marketplace. In the time that it takes to execute the required series of orders it is possible that the volume that the trader could have immediately accessed at an acceptable price may no longer be available.

Derivatives Related Trades:

An important aspect of the process of best execution is the analysis of costs and the comparison of actual implementation costs to expected implementation costs. Transactions cost estimates critically depend on the order size relative to the expected liquidity of the security or portfolio. The average daily volume of a security is a proxy for the expected liquidity of a security. Non-economic transactions (that do not involve a transfer of risk) such as Exchange for Physical and some other derivative related trades are not currently marked and are counted in the regular volume of a security. These transactions overstate true trading volumes and distort pre-trade cost estimates and post trade analysis. These transactions should have to be marked so analysts can filter them out of volumes for use in trading cost analysis.

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?*

If audit trail information is not easily accessible in electronic form then it is unlikely that the broker or investment manager is systematically analyzing the information to evaluate execution quality.

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 Concept Paper proposes the definition '*best execution is the best net result for the client, considering price, speed of execution, certainty of execution, and total transaction costs in light of the client's stated investment objectives*.' It qualifies this definition with the statement that '*in practice the best execution obligation is met by seeking to achieve this best net result and not necessarily by meeting an absolute standard. The specific application of the principle will vary with the needs of clients and of the particular security but, if challenged on whether best execution was achieved for a particular trade, the agent should be able to demonstrate that it has a defined process and that it has taken care in relying on this process.*'

Barclays agrees with this generalized definition that can be applied to brokers and investment managers. We would argue that total transaction costs should be defined to be implementation shortfall and so should consider expected market impact and opportunity costs.

<u>Question 6</u>: *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?

Timely post-trade transparency provides significant value to investors in their price discovery process. For example, recent studies of corporate bond data in the US following the TRACE data show significant declines in trading costs of corporate debt securities as execution prices have become more transparent in that market. Without this knowledge it is impossible to fully ascertain what the quality of a particular execution is likely to be, much less whether a best execution goal had been met. Thus, with each of the above security types more timely transparency, even once the trade has been executed, will be welcome and beneficial.

<u>Question 7</u>: *How should dealers in Canada monitor and measure the quality of executions received from foreign executing brokers?*

Dealers in Canada should monitor and measure the quality of executions received from foreign executing brokers by comparing realized execution prices against various benchmarks such as arrival price, volume weighted average price, and post trade price. A dealer who chooses an executing broker based solely on payment for order flow or reciprocal business, without critically analyzing the quality of execution, is not acting in the best interests of the client. The Canadian dealer would not meet a best execution standard.

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

The internalization of orders does not necessarily represent an impediment to obtaining best execution as long as the trades are reported in a timely manner post-trade. Even though internalized orders are not exposed to the market to interact with other orders, they still play a role in price formation if the transactions are visible as other traders will consider the market prices of the transactions and adjust their order prices accordingly. Where appropriate, Barclays feels that regulations should not prohibit institutional trades from “crossing” opposite side order flow for matched purchases and sales of securities for different clients. Crossing these orders helps to save clients money by eliminating the bid-ask spread and market impact costs and substantially reducing commissions potentially resulting in better execution quality. Any such crosses should however be implemented only with the knowledge of clients.

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 with fair prices)?*

For trades where a broker is selling a position from inventory the appropriate size of the mark-up will depend on the risk assumed which will depend on the characteristics of the trade including the price volatility and liquidity of the position. Competition should act as a limit on the potential size of mark-ups.

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?*

It is difficult or impossible to measure and track execution quality if there is no readily available market data to analyze. In a dealer market that does not have pre- or post- trade transparency, investors must rely on competitive bidding processes to increase the likelihood that they will achieve best execution.

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

Barclays does not believe that soft dollar arrangements are consistent with its best execution and other general obligations to clients.

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

No.

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?*

No comment.

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?*

We believe disclosure for third party soft dollar payments and bundled commissions should be different.

__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) The true unbundled commission for order execution may differ by trade, and there would be a cumbersome, arbitrary and costly exercise in determining the split for bundled services. Conversely, third-party soft-dollar costs should be relatively easy to track.
b) Allocation of all trades proportionally across all accounts when the trades have had the same trade motivation will normally result in a reasonable allocation when a commission has been split with reasonable accuracy (see comment above).

__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?*

Only the third-party soft dollar cost can be measured accurately and should be included in the operating expenses in the financial statements. The inclusion of commissions (outside of soft dollar commissions) in the operating expenses in the financial statements will simply encourage a significant shift of trading to a "principal" basis from an "agency" basis, with the potential for higher transactions costs absorbed by clients.

__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"?*

It would be appropriate for the MER to reflect the third party soft dollar payments made, of any type.

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

We believe they should be prohibited, as they involve an inherent conflict of interest. Please note that many participants in capital markets that are not advisors, such as pension funds, are active users of directed brokerage and commission recapture, and any regulation should address this as well.

Another practice, often associated with or referred to as “directed brokerage” and/or “commission recapture” is “**transition management**”. This concept of transition management is relatively new in a commercial sense, and certainly not dealt with uniformly in a regulatory sense. Transition management is a short-term portfolio management and trading exercise lasting from a few days to a few weeks, where a dealer or advisor restructures a client’s assets – typically large pension plans, endowments and foundations. Discretion is exercised as to when securities are traded but not as to which securities are traded, as the client will engage a transition manager to buy and sell a specific list of securities. The specific trade lists result from the termination and hiring of a long term investment advisor, changes in investment objectives, or from restructuring the asset mix (i.e. selling Canadian equities and buying US equities)

Transition management can be an example of the application of best execution obligations in that transition managers are asked to provide the client with explicit pre trade cost estimates and then provide post trade results relative to those estimates. The client and transition manager will have very explicit discussions on trade objectives, speed of execution versus price impact and opportunity risk, as well as the commissions to be earned on an assignment. Further, as mentioned under the “trade through” discussion above, the portfolio concept, and not the trade-by-trade aspect of best execution, is central to the transition assignment.

Transition management service providers include consultants, advisors and dealers, each with different fiduciary and best execution obligations as well as different inherent conflicts of interest. Transition management arrangements can also involve commission recapture and directed brokerage arrangements. We believe that in reviewing commission recapture and directed brokerage arrangements in the context of best execution, transition management arrangements should also be addressed

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

Yes.

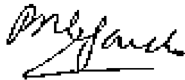
Question 20: *Would any of these initiatives be helpful in Canada?*

All three jurisdictions noted are still debating those initiatives, all of which are complex. Canada should exercise caution in considering the pursuit of initiatives from other jurisdictions until those jurisdictions actually implement said initiatives.

Conclusion

As stated above, this is a topic upon which Barclays places great emphasis and we therefore thank you again for the opportunity to comment on the Concept Paper. Please contact the undersigned or Warren Collier (416-643-4075 or warren.collier@barclaysglobal.com) if you have any questions, or would like additional information in respect of any of the points made in this letter.

Sincerely,



Rajiv Silgardo
President, CEO and CIO

Cc: Gerry Rocchi, Barclays
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