



Market Regulation Services Inc.

Services de réglementation du  
marché inc.

**James E. Twiss**  
Chief Policy Counsel  
Market Policy and General Counsel's Office

Direct Tel: 416.646.7277  
Direct Fax: 416.646.7265  
E-mail: james.twiss@rs.ca

145 King St. West  
Suite 900  
P.O. Box 939  
Toronto ON  
Canada M5H 1J8

T 416.646.7200

Suite 2600  
P.O. Box 11580  
650 West Georgia St.  
Vancouver, BC  
Canada V6B 4N8

T 604.602.6962  
F 604.682.8514

June 15, 2005

**BY E-MAIL**

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 ON M5H 3S8

- and -

Madame Anne-Marie Beaudoin  
Directrice du secretariat  
Autorité des marchés financiers  
Tour de la Bourse  
800, Square Victoria  
C.P. 246, 22e étage  
Montréal, Québec H4Z 1G3

Dear Members of the Canadian Securities Administrators:

**Re: Request for Comment – Concept Paper 23-402 - Best Execution and Soft  
Dollar Arrangements**

Market Regulation Services Inc. ("RS") is pleased to have the opportunity to comment on  
Concept Paper 23-402 - Best Execution and Soft Dollar Arrangements (the "Concept

Paper”) published by the Ontario, British Columbia, Alberta and Manitoba Securities Commissions and the Autorité des marchés financiers du Québec (the “CSA”). RS strongly supports the concept of best execution and best execution practices and is pleased that the CSA have provided this forum to further discussions on the issues related to best execution in the Canadian context. RS shall respond those questions posed in the Concept Paper which relate to matter within the jurisdiction of RS.

As you are aware, RS is presently undertaking a strategic review of the Universal Market Integrity Rules (“UMIR”). Part of that strategic review has involved posing questions and receiving comments relating to “best execution” including comments made by Participants, institutional investors, marketplaces and regulators during a series of “roundtable discussions” held late in 2004. RS will make reference throughout this letter to the comments received by RS on the subject of best execution as part of the strategic review.

*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?*

Current requirements, including Rule 5.1 of UMIR and section 4.2 of National Instrument 23-101 – *Trading Rules* (NI 23-101), focus on the obligation of dealers to ensure the best execution of client orders. In addition, UMIR Rule 5.2 imposes a “best price” obligation on dealers and NI 23-101 specifically sets out the obligation of a dealer, when acting as agent for a client, to take reasonable steps to achieve the best price for the client.

RS believes that dealers are aware of their obligation to provide a client with best execution. However, there is concern that some dealers may have difficulties reconciling potential conflicts between the dealer’s obligations to comply with requirements to provide best execution while also complying with the best price obligation. RS accepts, and expects, that the best execution of a client order may, in certain circumstances, result in a different trade than would have occurred had the dealer solely sought to obtain “best price”. The best price obligation imposed by Rule 5.2 and section 4.2 of NI 23-101 is qualified by a requirement to undertake “reasonable efforts” and Part 1 of Policy 5.2 lists five factors that RS will take into consideration when determining whether the Participant has in fact made reasonable efforts. These factors include:

- the information available to the Participant from the information processor or information vendor;
- the transactions costs and other costs that would be associated with executing the trade on a marketplace;
- whether the Participant is a member, user or subscriber of the marketplace with the best price;

- whether markets outside of Canada have been considered (particularly if the principal market for the security is outside of Canada); and
- any specific client instructions regarding the timeliness of the execution of the order.

RS believes that changes in regulations could provide dealers with additional clarification of their obligations where such a conflict may exist. RS has proposed specific amendments to UMIR to clarify the dealer's obligations to provide best price by specifically differentiating between the "trade-through" obligation and the obligation to obtain "best price" when handling a client order. These proposals are presently subject of a Request for Comments issued on May 12, 2005 as Market Integrity Notice 2005-016 – *Interim Provisions Respecting Trade-Through Obligations*.

RS believes that a general awareness about best execution obligations exists, particularly among advisers and marketplaces, but that client's knowledge as to their role is uneven. Sophisticated clients have a significant interest in, if not a clear understanding of, their role, and the role of their agent, in relation to best execution. RS also believes that many unsophisticated clients are not aware of best execution obligations and their roles with respect to best execution. RS believes that investor education would benefit dealers, advisers and clients.

*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?*

RS is of the view that prescriptive rules relating to best execution, while potentially desirable, would be impractical to administer. What constitutes best execution differs from order to order and will depend upon the market conditions at the time the order is made coupled with the needs and goals of the client. Best execution is a highly subjective concept and must be left to the discretion of the registrants. RS believes that registrants should be provided with guidelines in relation to best execution and on the elements and processes that must be in place in order to demonstrate after the fact that best execution has been achieved but that any further direction would be unhelpful. Each registrant should be responsible for evaluating and determining best execution in each separate situation.

Parties involved in RS's roundtable discussions were asked whether RS should consider adopting a "bright line test" for evaluating best execution. The responses generally did not favour the concept of having a bright line test. Respondents indicated that the concept of best execution and the fact that the elements which comprise best execution differ from trade to trade would make it impossible to create a formula for calculating best execution. The respondents participating in the discussions did support the idea of creating standards to provide some direction regarding the elements of best execution that should be considered. A minority of respondents, particularly those representing

Participants, supported the creation of a bright line test which would provide Participants with certainty regarding their obligations.

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

RS is of the view that the Concept Paper does identify the basic elements of best execution but believes that there may be other elements that may be considered including order size. Such elements which should be considered include:

- (a) Impact on Liquidity – this element is closely related to market impact however does not specifically relate to price movement. Execution of an order may provide signals to market participants which will lead to changes the entry or additional orders or the deletion of existing orders. The change in orders will have an impact on the liquidity of a security making it either easier or more difficult to execute additional or subsequent trades;
- (b) Market Impact – this element relates to the impact that an order may have on the market for the security which is the subject to the order, the market for securities in an industry or the market as a whole. An order may send out a signal relating to the expectations of the party entering the order which in turn may have an impact on the price of the security, an industry or a whole market. For example a respected portfolio manager entering a large sell order relating to a number of securities issued by energy companies can signal participants that the manager believes that the sector is overvalued which may lead to lower prices for energy securities. The portfolio manager would be wise to consider such an impact as element which may affect his analysis of best execution; and
- (c) Ease of Execution – there may be some situations where ease of execution is a consideration for best execution. Where a method of execution is sufficiently complex or presents a risk of liability on the party executing the trade it may be an element that should be considered in evaluating best execution.

Participants in RS's roundtable discussions were asked what elements, other than price, should be considered when assessing best execution. Respondents in these discussions agreed that price was merely one factor in determining best execution and suggested that other factors, including the ability to execute the trade in an orderly manner, transaction costs, impact of the orders on the market for the security and the ease of execution.

*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?*

The electronic audit trails plays a vital role in measuring execution quality. A registrant cannot be expected to consider information which is not readily available when making execution decisions. RS believes that audit trail information must be available in an easily accessible form to allow all participants to evaluate execution options using timely, accurate information.

However, RS does not believe that the production of periodic “best execution” reports by marketplaces or dealers as is required in the United States would be productive. These reports provide a mass of data but little in the way of information that would be meaningful for most investors, particularly retail investors. In the view of RS, resources that would otherwise be devoted to the production and dissemination of such reports are better deployed in ensuring a minimization of trade-throughs of orders on Canadian marketplaces.

*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?*

RS agrees with the general elements of best execution outlined in the Concept Paper and also agrees with the approach emphasizing the process to seek best execution as opposed to determining more prescriptive rules. For purposes of clarity the CSA should provide additional clarification of the application of best execution obligations in situations where such obligations conflict with other regulatory obligations such as trade-through obligations. Registrants should be made aware whether trade-through or other obligations supersede their obligations to achieve best execution.

*Question 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?*

RS believes that quality of execution of equity securities may be inhibited by a number of factors. In general quality of execution is adversely affected whenever market participants are unable to obtain timely and accurate data relating to execution opportunities. Lack of pre-trade transparency relating to trading opportunities hampers the ability to achieve best execution for all types of securities. While there may be legitimate reasons to wish to limit pre-trade transparency these must be weighed against the negative impact such limits have on execution quality.

In addition RS believes that the quality of execution for equity securities listed or quoted for trading on a marketplace in Canada is adversely affected by a lack of visible liquidity on Canadian marketplaces. Increased visible liquidity provides all participants with additional information to assess execution opportunities.

While pre-trade transparency will allow participants to assess execution opportunities it should be noted that requiring such transparency may have adverse consequences. The imposition of such transparency could inhibit the ability of some investors to achieve best execution as transparency will provide other participants in the market with information regarding the investor's intentions and may take advantage of such knowledge to the detriment of the party desiring to execute the trade.

The best available execution would have been facilitated in a trading environment based on market integration. However, the Canadian Securities Administrators determined that a data consolidator would not be practical. As such, when National Instrument 21-101 was introduced it required all marketplaces to maintain an electronic connection to every other marketplace that traded the same security. The electronic connection between marketplaces would have permitted the "migration" of orders to trade as against the best available prices on any other marketplace. In this way, market participants did not have to maintain access to each marketplace in order to be in a position to immediately access available liquidity pools. In the view of RS, the amendments to National Instrument 21-101 in January of 2004 to eliminate the electronic connection between marketplaces significantly complicated the ability of market participants to ensure that they can obtain best execution in circumstances when there are multiple marketplaces trading the same securities.

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

RS believes that the internalization of orders represents a significant impediment to obtaining best execution, both for the order which has been retained internally and for all other market participants who may wish to execute a trade relating to the same security. However, that being said, the impact of internalization has, up until now, been ameliorated by the requirement that all trades resulting from internalization had to be executed on a marketplace within the context of the prevailing market spread. If orders which have been internalized can be "printed" on a marketplace at any price irrespective of orders on other marketplaces then the continuation of the practice of internalization

will make it significantly more difficult to demonstrate that a client's order has obtained best execution.

The internalization of orders by registrants inhibits the flow of information which is vital in achieving best execution. Without entry of the order on a marketplace which offers pre-trade transparency execution opportunities will be limited and other marketplace participants which otherwise would consider execution options if made aware of the order can not make such considerations.

In addition, the internalization of order flow contributes to a lack of liquidity in marketplaces which also represents an impediment to achieving best execution, as previously discussed.

*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?*

RS believes that both pre-trade and post-trade transparency aid in achieving best execution and are necessary elements in tracking and evaluating execution quality. Without such information, execution opportunities can not be evaluated either prior to or subsequent to execution. Where there is no universal pre-trade transparency, participants will not be able to effectively evaluate all alternative trading opportunities. Where there is no post-trade transparency the evaluation of the quality of execution is made very difficult as there will be no data with which a participant can compare their execution.

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

While RS does not have a position with respect to the limitation or prohibition of commission recapture arrangements, RS generally supports the concept of requiring disclosure of such arrangements. The disclosure of such arrangements would ensure that execution decisions would be made with full information relating to costs (including cost recovery). RS believes that the consideration of the costs of execution is an important element in assessing best execution opportunities. UMIR Rule 5.2(3) (Best Price Obligation) specifically cites transaction fees as one element to be considered when evaluating best price obligations.

Without full disclosure of directed brokerage or commission recapture arrangements clients may end up paying higher fees for execution of trades on some marketplaces than necessary, which may result in less than fully informed execution decisions.

As discussed between RS and the CSA at the last oversight meeting, RS will not publish specific proposals relating to best execution until the CSA has considered the responses to the Concept Paper. As a result, RS and the CSA will work together and coordinate any changes to the rules and regulations relating to best execution that will follow the CSA Concept Paper and the RS strategic review of UMIR. We look forward to working with you on this project.

Yours truly,

***“James E. Twiss”***

James E. Twiss,  
Chief Policy Counsel.