



Canadian Foundation *for*  
Advancement *of* Investor Rights  
Fondation canadienne *pour* l'avancement  
*des* droits *des* investisseurs

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**RE: IIROC Notices and Request for Comment: Proposed Rule and Guidance on Best Execution –  
Notices 16-033 and 16-034**

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FAIR Canada is pleased to offer comments on the issues arising from IIROC's revised proposed amendments to Rule 3300 of UMIR on best execution, and the related proposed guidance, as set out in Notice 16-0233 Re-Publication of Proposed Provisions Respecting Best Execution (the "Proposed Amendments") dated October 13, 2016 and Notice 16-0234 Re-Publication of Proposed Guidance Respecting Best Execution dated October 13, 2016 (the "Proposed Guidance") (both hereinafter referred to as the "Proposals").

FAIR Canada recognizes that the Proposals are updated versions of proposals first made in December 2015. FAIR Canada did not comment on the earlier proposals but wishes to take the opportunity to comment on the proposed regulations on best execution at this time.

FAIR Canada is a national, charitable organization dedicated to putting investors first. As a voice for Canadian investors, FAIR Canada is committed to advocating for stronger investor protections in securities regulation. Visit [www.faircanada.ca](http://www.faircanada.ca) for more information.

## **1. Introduction and Summary**

- 1.1. IIROC's Proposed Amendments require its dealer members to establish and follow "policies and procedures that are reasonably designed to achieve best execution", rather than requiring dealers to provide clients with best execution of their orders, as UMIR Rule 5.1 currently does. The Proposed Amendments set out many required factors and elements to be covered in such policies. The Proposed Guidance explains the operation of the rule and expands on the factors and issues that dealers should take into account in addressing their duty to provide best execution to clients.
- 1.2. **FAIR Canada believes that a dealer member's duty to obtain best execution of client orders is a central tenet of investor protection and of the broader duty that we believe dealers should**

**have to their clients: to act in their best interests.**<sup>1</sup> If a dealer fails to obtain best execution for a client, it has failed to act in the client's best interest.

- 1.3. **As an advocate for investor rights, FAIR Canada finds it disappointing that the regulators are no longer able to require compliance with dealers' duty to provide best execution of client orders on each trade made by a client.** We also take exception to the fact that IIROC's Notice does not appear to address the impact of the Proposals on investors, just the impact on its dealer members.
- 1.4. As a result of Canada's market structure, IIROC has determined that "...a Dealer Member, particularly when executing orders on an automated basis, may not be able to achieve best execution for every single order it executes on behalf of a client."<sup>2</sup> This fact raises important questions about the current level of investor protection, including, what is the expected degree of compliance in providing clients with best execution on transactions? Unfortunately, that question is not answered in the 6-page proposed Rule 3300 or the 24-page Proposed Guidance. In fact, the rule only contains a single reference to the actual results achieved in executing clients' orders in the markets: "how the Dealer Member evaluates whether its policies and procedures are effective in achieving best execution"<sup>3</sup> is one of six elements of the process for the review of its policies and procedures that a dealer must put in place.
- 1.5. The Proposals illustrate how complex the markets are today, with the advent of multiple markets, "non-protected markets", payment for order flow and so on. In effect, the Proposals acknowledge that a client may not receive the best available price on an order and that is one of the many costs of accommodating multiple markets with multiple features. Many of these features are designed to attract high frequency traders (HFT) and other types of algorithmic trading from firms that generate very large volumes of order flow. Investors who benefited from simple time / price priority are paying the price for those changes, in this case through compromises being made on the duty of best execution.
- 1.6. **Best execution is of central importance to investors' interests, fair markets and market integrity.** It reflects the standard of care that a dealer owes to clients when acting as their agent in filling orders to trade in the securities markets: to obtain the best price possible in the context of the details of the order and the circumstances in the markets. FAIR Canada believes that should normally translate into the best available price in the market when trading orders for retail clients. In that sense the duty reinforces market integrity by requiring that the bids and offers posted at the best price in the market be filled first, in most cases.
- 1.7. **FAIR Canada believes that the Proposals would qualify dealers' duty of best execution by fundamentally changing the test of compliance with the duty. Therefore, in our view compliance with the regulations must be subject to close scrutiny and ongoing monitoring**

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<sup>1</sup> FAIR Canada letter to CSA dated February 22, 2013 re Consultation Document 33-403: The standard of conduct for advisers and dealers: Exploring the appropriateness of introducing a statutory best interest duty when advice is provided to retail clients, at p.31; available online at: <http://faircanada.ca/wp-content/uploads/2013/02/130222-final-Statutory-Best-Interest-Submission.pdf>.

<sup>2</sup> IIROC Notice 16-0234, at p. 7.

<sup>3</sup> Rule 3300.8, as contained in IIROC Notice 16-0233, at p. 22.

**to ensure that they in fact achieve the intended purpose of ensuring that clients receive best execution.** Since the Proposals only require dealers to adopt and follow policies and procedures “reasonably designed to achieve best execution”, they are a qualification of the duty. The test of compliance will no longer be the results obtained for clients on the markets, but the adoption of appropriate written procedures. The Dealer Member will be expected to “monitor its execution quality by conducting internal testing and retaining records of the internal testing to ensure that *the policies and procedures are being followed and are effective* in achieving best execution.” (our emphasis) This appears to be a watered-down test that provides less protection to clients.

- 1.8. **A client can often assess whether he or she got best execution on an order, especially if the best available price was not received on a small order. Only a regulator can assess a dealer’s policies and procedures.** As explained below, the regulators’ assessment will inevitably be a subjective one given the wide range of factors to be considered in developing the policies and procedures and the various order routing decisions that those policies could permit. This will make enforcement of the proposed rule difficult, as explained below. In such circumstances, we view the disclosure of a firm’s policies and procedures on best execution to be of little practical use, except perhaps for very large institutions. Disclosure of policies will not improve clients’ ability to receive best execution of their orders.
- 1.9. **FAIR Canada believes that IIROC’s Proposals fall short of the standard of compliance and review that should be in place if such a fundamental change to one of the core duties of an investment dealer to its clients is made.** We acknowledge that in today’s complex market environment, it may not be possible to ensure best execution on every trade. But we believe that this change poses risks to investors; individual investors in particular. There is a risk that securities markets will be less fair for investors, especially if the change will not be accompanied by robust requirements to monitor, test and assess the extent to which dealers deliver best execution to their clients.
- 1.10. **FAIR Canada believes that the Proposed Amendments should include a dealer’s effectiveness in obtaining best execution for clients as one of the tests of compliance. The Proposed Amendments should also require dealers to perform minimum standards of compliance monitoring and regular assessments of their effectiveness in obtaining best execution for clients, in particular retail clients and not simply a process that specifies how the dealer evaluations whether its policies are procedures are effective.** Those should be mandatory, not just in the Proposed Guidance as proposed in the Proposals. Details are provided below.
- 1.11. FAIR Canada supports certain aspects of the Proposals, in particular extending the best execution obligation to all orders received from a client for execution in any type of market.

## **2. Failure to address the impact of the Proposals on investors**

- 2.1. **FAIR Canada objects to the fact that the IIROC Notice 16-0233 only addresses the impact of the Proposals on IIROC’s Dealer Members and does not acknowledge the Proposals’ impact on investors.**

- 2.2. The four most significant impacts on dealers are listed in Notice-16-0233. However, no impacts on investors are listed in spite of the fact that one of the primary impacts – that an investor may not receive best execution on a given trade – is much more significant than, for example, the fact that dealers will have to train employees on their best execution policies.
- 2.3. Since IIROC’s consultation process on rule proposals provides an opportunity for all participants in the market to comment, and to address the interests of all stakeholders, the impact on all affected stakeholders should be addressed. The potential impact on investors should be one of IIROC’s primary concerns when making regulatory proposals. How did IIROC determine that the Proposals assist Dealer Members in “promoting the protection of investors” if the impact on investors was not explicitly addressed?
- 2.4. **The Notice does not give due regard to the major change in the regulatory treatment of the best execution obligation to be made under the Proposals. Current UMIR Rule 5.1 reads clearly and simply: “A Participant shall diligently pursue the execution of each client order on the most advantageous execution terms reasonably available under the circumstances.”** The requirement of due diligence will be eliminated, and not just with reference to “each client order”. While the Proposals will apply to OTC securities and trades outside of Canada as well as trade in listed markets, and therefore apply more broadly than UMIR 5.1, in substance they appear to weaken the duty of best execution.

### 3. Mandatory requirements to conduct compliance monitoring and assessment

- 3.1. **FAIR Canada recommends that Dealers’ obligations to perform compliance monitoring and regular assessments of their policies’ effectiveness in obtaining best execution should be in the rule itself as mandatory requirements. IIROC should set out expected minimum standards for compliance monitoring and assessment in the Guidance.**
- 3.2. The Proposed Guidance states that as part of a process for review of compliance with the best execution obligation, a dealer “is expected to monitor its execution quality by conducting internal testing and retaining records of the internal testing to ensure that the policies and procedures are being followed and are effective in achieving best execution”.
- 3.3. FAIR Canada strongly recommends that the expectation should be required in Rule 3300 itself – it should be a mandatory, enforceable requirement. The following mandatory requirements should be imposed in the Proposed Amendments:
  - 1) Dealers should be obligated to adopt a compliance monitoring system to monitor, on an ongoing basis, whether its best execution policies and procedures are working effectively. The system should consist of regular “trade testing”. IIROC should adopt recommended minimum standards for such systems, which should be set out in the Proposed Guidance.
  - 2) Dealers should be obligated to carry out regular assessments of the results obtained for their clients in executing trades, using the results from the compliance monitoring system proposed in requirement (1) above. These assessments should be the main

factor considered in the regular review of a dealer's best execution policies and procedures under section 3300.8 and in setting parameters for order routing systems and decisions. Dealers should be required to take action if their assessments show that their policies are not effective in delivering best execution for clients.

- 3.4. The Proposed Guidance states, "Under Rule 3300, Dealer Members must keep documentation respecting internal testing and decisions made concerning best execution... " (page 16). We do not see that requirement in the Proposed Amendments, which do not mention "testing". Section 3300.8 requires a dealer to retain records of its reviews of its best execution policies and procedures, but does not expressly require retention of evidence of compliance monitoring, trade testing or assessments. We recommend that it be specifically required.

#### 4. IIROC's supervision of compliance with the rule

- 4.1. FAIR Canada recommends that IIROC adopt a documented supervision program to review its members' compliance with the Proposed Amendments. The supervision program should consist of ongoing off-site monitoring of best execution reporting that dealers should be required to file with IIROC, and a revised module on best execution for use in IIROC's regular cyclical examinations of members. Off-site monitoring should encompass 1) periodic reporting by firms of their assessments of results obtained for clients in executing trades, and 2) mandatory reporting by firms when they change their best execution policies and procedures.
- 4.2. FAIR Canada also recommends that IIROC should carry out periodic assessments of the effectiveness of the new rule in delivering best execution to clients, based on dealers' filings with IIROC, IIROC's examination program, and other research as needed. IIROC should report the results of its assessments publicly – for the benefit of investors, its members, regulators and other stakeholders. Such a report should be released after analyzing one year's experience with the new regime, and periodically thereafter. Conducting assessments of the rule's effectiveness in ensuring best execution and publicizing the results would reassure investors, regulators and the industry itself that the new approach to compliance with the best execution is working as expected, if that is the case. If not, the assessments should lead to changes in the regulatory approach.

#### 5. Enforcement of compliance with the proposed rule and the test of compliance

- 5.1. FAIR Canada believes that the Proposals should be strengthened by expressly **including the results achieved for clients in obtaining best execution as one of the tests of compliance with the best execution obligation**. In FAIR's view, the Proposals place excessive emphasis on processes over the substantive results achieved for clients in executing their orders. We predict that it will be difficult to enforce compliance with the duty of best execution in a meaningful way based on an assessment of a dealer's policies and procedures and its process for achieving best execution, for the reasons noted below.
- 5.2. The Notice states that under the Proposals, "... evaluating best execution compliance would be based on reasonably designed policies and procedures rather than on a trade-by-trade

analysis.”<sup>4</sup> We do not believe that is adequate in and of itself. **Compliance must be evaluated not only based on an assessment of policies and procedures, but also on the results that a dealer achieves for its clients.** Even if policies and procedures appear to be reasonable, or are defensible because all the necessary factors required to be covered by the rule are addressed, such policies and procedures are not adequate if they do not deliver the results for clients that they aim to achieve.

- 5.3. If the proposed test of compliance is part of the rule, there will be a need to include in the rule a dealer’s obligation to carry out compliance monitoring and regular assessments of its policies’ effectiveness in obtaining best execution, as we recommend in point 3 above.
- 5.4. We note that the Notice does state that IIROC will use data collected on OTC debt transactions through its Market Trade Reporting System to assess a member’s policies and procedures in that market (which must be designed to obtain prices that are “fair and reasonable”). A commitment to using a similar data-based approach to assessing best execution policies and procedures in other markets should be explicitly made part of the rule.
- 5.5. **The compliance test should not only be based on an assessment of a firm’s policies and procedures because a wide range of policies may be considered to be “reasonably designed to achieve best execution”. Such flexibility will make enforcement difficult.** The flexibility that the Proposals provide to dealers in designing their best execution policies and procedures is inherent in the reasonableness standard set by the Proposals. The regulator would need to establish that a dealer’s policies are unreasonable to find a firm in violation of the Proposed Amendments. That would be a challenge, given that reasonableness is a subjective test, and that many of the factors to be addressed in the policies are general in nature and could support decisions to route client orders to markets in various ways.
- 5.6. As long as a dealer considers the factors that considerate is required to consider in setting its policies and procedures, it will be very difficult for IIROC to find that a dealer has failed to comply with the Proposed Amendments as currently worded, even if its trading records show that it failed to obtain best execution on a significant percentage of its client orders. IIROC will likely only be able to find non-compliance if a dealer fails to establish a thorough set of policies and procedures in accordance with the requirements, or fails to follow them, or perhaps if the policies are demonstrably unreasonable. Presumably a failure to obtain best execution most of the time would at least provide evidence that a firm’s policies are inadequate, but it should be a specific requirement of the rule that the policies effectively deliver best execution for clients, including retail clients.
- 5.7. **In addition, the “factors” that dealers must address in setting their policies and procedures provide additional flexibility for dealers.** The factors are general statements of policy that in most cases are open-ended or cover basic sound practices. Many of the factors are general in nature and somewhat vague; for example, “factors related to executing on unprotected marketplaces”.<sup>5</sup> The policies and procedures will need to be flexible because whether a

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<sup>4</sup> IIROC Notice 16-0233, at p.7.

<sup>5</sup> Under the Proposals, dealers are obligated to address a range of factors in setting their best execution policies and procedures, including:



market might provide best execution for a particular type of order in a specific security will vary widely.

- 5.8. Furthermore, since securities markets are very dynamic and the market structure and market share of different marketplaces is constantly changing, how best execution can reasonably be achieved for a particular security will change frequently. Policies that attempt to address the wide range of orders, order sizes, client types, and types of securities traded by a dealer, as well as the range of marketplaces used by a dealer, may not be very useful in delivering best execution for a particular order in a specific security.
- 5.9. The Proposed Amendments is over 6 pages long and it takes 24 pages to provide guidance on the rule. FAIR Canada recognizes that there are complexities involved in complying with the Proposals which will make enforcing compliance challenging. FAIR Canada urges IIROC to more explicitly address this in the Proposed Amendments and Proposed Guidance.

## 6. Conflicts of interest and payment for order flow

- 6.1. **The Proposals should specifically address the conflict of interest between a dealer and its clients when payment for order flow is a factor in order routing decisions.** The Proposals require dealers to “include any material conflicts of interest that may arise when sending an order for handling or execution”. In our view the receipt of payment for order flow is always a material conflict of interest. That provision should be amended to expressly cover payment for order flow. If a dealer considers, or may consider, payment for order flow in any of its order routing decisions, that factor should expressly be covered in its best execution policies and procedures, with a description of the circumstances in which payment for order flow may be accepted, and an explanation of how the dealer will prevent a conflict of interest based on payments for order flow from interfering with its duty to obtain best execution.
- 6.2. FAIR Canada supports adding a requirement for a dealer to disclose whether it bases *any of* its order routing decisions on fees paid or payments received.

## 7. Disclosure of best execution policies to clients

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- considerations taken into account when determining appropriate routing strategies for clients
  - how order and trade information from all appropriate marketplaces, including unprotected marketplaces and foreign organized regulated markets, is taken into account
  - factors related to executing on unprotected marketplaces
  - factors related to sending orders to a foreign intermediary for execution.

The risks for investors of the Proposals’ approach to best execution are evident from the fact that prevailing market conditions, such as the last sale prices and market depth, must only be considered by a dealer when manually handling a client order (see 3300.3 (c)).

The policies and procedures must then outline “a process designed to achieve best execution”, which for listed securities includes:

- identifying the Dealer Member’s order handling and routing practices intended to achieve best execution
- taking into account the order and trade information from all appropriate marketplaces
- explaining the rationale for accessing or not accessing particular marketplaces
- any arrangements to access a marketplace that has historically demonstrated a reasonable likelihood of liquidity for securities for which the Dealer Member accepts orders.

- 7.1. FAIR Canada does not believe that the requirement to disclose best execution policies to clients in section 3300.11 provides meaningful protection for clients, especially retail clients. IIROC states in its Notice that it does not expect the disclosure to be highly detailed but it should provide enough information for clients to understand how their orders will be handled. However, the required content of the disclosure in section 3300.11 is quite detailed. Retail clients are not likely to read or understand detailed disclosure about different marketplaces and order routing policies. Clients are highly unlikely to move their accounts from one dealer to another based on a dealer's best execution policies, even if clients could understand how those policies would affect execution of their orders.
- 7.2. We believe that the disclosure could be misleading if it leads clients to believe they will receive best execution of their orders. Under the Proposals a dealer is only obliged to provide best execution on a "best efforts" basis by following the policies and procedures that it puts in place. FAIR Canada recommends that IIROC test any proposed disclosure with clients, especially retail clients, and publish the results, before relying on disclosure as a possible measure.
- 7.3. Further, a risk arises that dealers or regulators will use the disclosure as a defence against any complaints that a client did not receive best execution. They will be able to point to the disclosure as providing notice of how orders are handled and the fact that best execution may not be received on a particular order. In fact, the disclosure may be more useful in serving the interests of dealers and the regulatory system than it is in helping clients protect their interests.

## 8. Extending the best execution obligation to all client orders

- 8.1. FAIR Canada supports the requirement to extend the best execution obligation covered by the Proposals to any client order in any security. We agree that the obligation is not limited to listed securities and IIROC's rules should reflect that.

## 9. Transactions in OTC securities

- 9.1. FAIR Canada supports including any mark-up or mark-down in the price on principal transactions, and any added commissions, in assessing whether a price for OTC securities is "fair and reasonable". It is obvious that obtaining a fair price for a security in an OTC market is of no benefit to the client if the net price paid or received by the client after any markup and commission does not reflect the transaction price, or is worse than the price that could have been obtained by executing the order elsewhere.

## 10. Prohibition on sending orders in bulk

- 10.1. FAIR Canada supports the prohibition of sending orders in bulk to a foreign intermediary without considering other liquidity sources, including liquidity sources in Canada. It is obvious that a general policy of routing orders to another intermediary based on payment for order flow could not be supported based on "policies and procedures reasonably designed to achieve best execution for a client" unless the intermediary guarantees to fill all orders at a



price at least equivalent to the best bid or offer available on Canadian marketplaces, as well as on US markets in the case of an American intermediary.

## 11. Changes to the 2015 Proposed Amendments

11.1. FAIR Canada notes that the Proposals make a number of changes to the “2015 Proposed Amendments”. Generally we are supportive of the changes, but note that the policy decisions reflected in the changes illustrate how complex the operation of the new Proposals will be, and the level of detail involved in the factors that firms must consider in preparing policies and procedures and making order routing decisions. As noted above, we believe that complexity will make enforcement of compliance with the new Proposals difficult, especially as it is currently worded.

We thank you for the opportunity to provide our comments and views in this submission. We would be pleased to discuss this letter with you at your convenience. Feel free to contact Marian Passmore at 416-214-3441 / marian.passmore@faircanada.ca.

Sincerely,



Canadian Foundation for Advancement of Investor Rights

CC: British Columbia Securities Commission  
Alberta Securities Commission  
Saskatchewan Financial Services Commission  
Manitoba Securities Commission  
Ontario Securities Commission  
Autorité des marchés financiers  
New Brunswick Securities Commission  
Registrar of Securities, Prince Edward Island  
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