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

We are writing to you on behalf of The Investment Funds Institute of Canada (“IFIC”) and its Members to comment on Canadian Securities Administrators’ (“CSA”) Concept Paper 23-402, Best Execution and Soft Dollar Arrangements (the “Concept Paper”). We understand that, in addition, several of our Member firms intend to submit comment letters directly.

IFIC is the national association of the Canadian investment funds industry. IFIC’s membership includes fund managers representing nearly 100% of the total mutual fund assets under management in Canada, retail distributors and affiliates from the legal, accounting and other professions.

We appreciate the opportunity to provide the following comments on the Concept Paper and applaud the CSA for undertaking this comprehensive review and seeking stakeholder input on this complex issue.

We will first offer some general comments, followed by responses to the questions raised in the Concept Paper, on the subject of best execution, and then our general comments and responses on soft dollars. We may wish to tender further comments to the extent we develop additional or alternative responses after submission of this letter.

As an introductory remark, we believe that there is a significant degree of confusion and misunderstanding surrounding best execution and soft dollar arrangements. The manner in which these terms are defined, and the descriptions of how the processes function, are often the result of misinformation. Given that the Concept Paper is consultative and written at a conceptual level, rather than presenting a particular set of proposals or reforms, we have prepared our response in order to educate and clarify, as well as to present our Members' comments and concerns with respect to the content of the Concept Paper.

We stress that in today's international financial markets, locally-focused discussions and solutions concerning best execution and soft dollars are of limited value. In a global market where Canadian investment fund managers regularly execute portfolio trades through U.K. or U.S. broker-dealers, and where the investment portfolios of a number of Canadian mutual funds are managed by non-Canadian advisers, an Ontario-only or Canada-only position with respect to best execution and soft dollars that is inconsistent with the positions in those other jurisdictions will serve only to generate compliance difficulty, additional cost and increased inconsistency within the industry. For this reason, IFIC encourages the CSA to ensure that an approach be adopted, inclusive of definitions and procedures, that is similar to, or at a minimum consistent with, the approaches being considered in the other large market jurisdictions, such as the U.S. and U.K. In addition, to maintain a level playing field, such approach must be harmonized throughout the industry, applying not only to mutual funds, but to all investment funds including pension plans, segregated funds, hedge funds and brokerage products.

A. Best Execution:

General Comments:

We concur with the Concept Paper statement that best execution is primarily the responsibility of the executing dealer; however, all parties to the transaction have a responsibility. Consistent with the duty to act in the best interests of its fund, for each portfolio transaction a mutual fund portfolio adviser's trader assesses which dealer, from among those with whom the trader has a relationship, can deliver the best result for the client (in this case the mutual fund), considering the requirements of that client.

We also agree that currently there is no consensus as to what constitutes best execution, or how it should be measured in order to ensure the parties have met their responsibilities. As a matter of definition, we do agree that best execution is the outcome of a process comprising a number of elements, significantly: price, speed of execution, certainty of

execution, total transaction cost, a dealers' willingness to commit capital and preserving anonymity and the client's requirements. The following definition is included in The Committee of European Securities Regulators ("CESR") Second Consultation Paper:

"...investment firms [must] take all reasonable steps to obtain, when executing orders, the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order.

*Nevertheless, whenever there is a specific instruction from the client the investment firm shall execute the order following the specific instruction."*¹

The assessment of best execution is a developing issue. There is no consensus as to how execution should best be measured. It is clearly not simply "best price". Although portfolio advisers seek best execution, they cannot always quantitatively explain what that means or demonstrate whether they have achieved it. Best execution is measured after the trade, reviewing the market conditions at that time. A typical analysis consists of a comparison of the order fill to the volume-weighted average price of the relevant security. Many would argue that a pre-trade analysis is also required in order to properly measure best execution, although it is not yet clear how this could best be achieved. Trade execution measurement requires evaluation of subjective, objective, qualitative and quantitative factors. There are also a number of participants, each with unique, relative obligations – the portfolio adviser's traders operate within parameters established by fund managers and give instructions based on the client's requirements; brokers follow instructions specified by the portfolio adviser's traders; and exchanges or other markets execute the trades according to the instructions of brokers.²

The CFA Institute definition of best execution for firms recognizes the complexity of this issue. It notes that best execution:

- (a) is intrinsically tied to portfolio-decision value and cannot be evaluated independently;
- (b) is a prospective, statistical and qualitative concept that cannot be known with certainty, *ex ante*;
- (c) 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; and
- (d) is interwoven into complicated, repetitive and continuing practices and relationship³

Accordingly, while we do not believe best execution regulation is required, we would encourage the development of consistent definitions and measurement tools and standards to enable better information and better analysis of the execution process.

Responses to Concept Paper questions concerning Best Execution:

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?

Response:

As noted in our general comments, mutual fund portfolio advisers must select executing dealers for portfolio transactions based on an assessment as to which dealer can provide the client with the best results. This responsibility arises from a manager's duty to act honestly, in good faith and in the best interests of the mutual fund, exercising the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances. Mutual fund investors are aware of this duty and standard of care. In this light, and given the complex process of assessing best execution, we do not consider that a program of investor education specifically on the principles of best execution would be of any practical value.

Many market participants, including the investing public, would argue that best execution is a very small issue relative to fund performance. As such, selection of the appropriate portfolio securities within the fund's investment objective has significantly greater impact than how well the trades in those securities were executed. It is unlikely that any two securities are so equal in attribute that the choice of execution should be the sole criteria.

The Concept Paper identifies that there is presently no consistency among regulatory provisions, not only in Canada, but also among other jurisdictions. We submit that a primary goal of the CSA should be the adoption of definitions of best execution that are consistent or identical with those in the other major capital markets around the world. Initially this should result in greater clarity as to what it means, which should assist in improving the measurement and consequent disclosure of the achievement of best execution.

Question 2:

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

Response:

No. We submit there will be no value to more prescriptive rules governing best execution. Best execution may be a theoretically repetitive process, but it will vary and

the results will depend on the circumstances and conditions existing at the time of each and every trade. Given this, we believe that, if any rules are contemplated, a principles-based approach is most appropriate where registrants be allowed the discretion to meet their obligations as they deem best.

As it is, dealers are already subject to rules obligating them to provide best execution. National Instrument 23-101, Trading Rules, requires a dealer acting as agent for a client, or as an intermediary for the client, to make reasonable efforts to ensure the client receives the best execution price on a purchase or sale of securities (it is notable that this Instrument focuses on price). As already noted, mutual fund portfolio advisers who purchase execution services from those dealers must satisfy themselves that best execution was in fact provided in each case. The difficulty is in demonstrably measuring best execution for compliance.

Without doubt, the primary goal should be on the development of consistent definitions of best execution and industry-wide measurement standards so that dealers will be able to demonstrate tangibly, and purchasers of execution services will be able to measure more consistently and with more confidence, dealers' performance.

In the end, as best execution is the outcome of a process that is unique to each portfolio trade, the methods for meeting the best execution obligation must be left to the discretion of the executing dealers, and the determination of whether the obligation was in fact satisfied in each case must be left to the discretion of the purchaser of those services. If a consistent understanding of the process is put in place, executing dealers and their customers will better be able to meet, and to demonstrate that they have met, their respective obligations.

Question 3:

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

Response:

We repeat our view that the definition of best execution should, to the extent possible, be standardized with the definitions that have been adopted or that are under development in other jurisdictions. To the extent it is desirable to enumerate all relevant elements comprising best execution, and not simply the most significant, we would suggest including several additional factors listed in the CESR definition namely, size of trade, likelihood of settlement, preservation of client anonymity, the nature of the trade and the broker's willingness to commit capital, as well as including an express reference to the client's objectives and requirements in the description of the elements to consider in the best execution process.

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?

Response:

Some of our larger IFIC Members have implemented electronic audit trail systems, whereas other Members rely on a manual system. Either system is appropriate for measurement of execution quality if it yields the necessary audit information to permit this determination. Although the information capture methodology may differ by manager, typical best execution measurement procedures include specifically designed questionnaires administered by equity traders to evaluate execution on a qualitative basis. Such questionnaires focus on speed and quality of execution and can be used to rate dealers based on the results. Any concerns that a particular dealer may not have executed as desired will factor into the portfolio adviser's future portfolio trade allocations.

We are aware of the CSA's initiative to develop and implement an electronic audit trail system, with initial implementation for listed equities and subsequent expansion to other asset categories.⁴ We understand this complex initiative promises to be a multi-year, phased-in project that remains several years away from initial implementation. Accordingly we submit that a manual audit trail methodology may remain the "state of the art" for many of our Members for the foreseeable future.

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?

Response:

As stated earlier, we agree that best execution can only be seen as the outcome of a process that considers numerous factors. The ultimate goal for an executing dealer must always be the best net result for its client, consistent with the client's requirements. Similarly, a mutual fund portfolio adviser's goal in selecting executing brokers is to ensure that its clients (the mutual funds and the investors in those funds) receive the best net result consistent with its/their requirements.

We emphasize the desirability of measurement methodologies so that each of the participants in the trading process is able to measure and demonstrate the quality of the execution it has achieved or received. However, we repeat that the majority of investors in our Members' funds, and by extension our Members, remain primarily focused on the

overall performance achieved by the funds, a result more of the portfolio securities held than the quality of execution of the trades involving those securities.

As this is a developing topic, we would be pleased to assist in the study and adoption of measurement criteria and methodologies should the CSA determine that further work in this area is warranted.

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?***

Response:

By far the bulk of the discussion concerning best execution relates to transactions in listed equities. In our view, trades in Canadian-only and inter-listed equities raise the least number of issues, and those issues have been extensively discussed in the Concept Paper. Certainly the efficiency of markets, increase in automation of transactions and greater availability of information better enables the monitoring of execution performance. Foreign-only listed equities raise the issue of availability and quality of information. In this context, our recommendation for adoption of consistent or identical best execution standards would significantly improve the measurement of execution quality in all major markets.

The issue of availability of trade information in the context of unlisted equity securities and derivatives is significant. Given that fewer dealers may be able to execute such trades, the ability to measure the quality of the trade (by using comparative information) is reduced. Here again, however, the adoption of a consistent “best execution is a process” approach would be very helpful. The lack of comparative information would simply be one of the additional factors to be considered in the measurement of best execution in each case. The result may be a decision by the portfolio adviser to alter the execution instructions in relation to future such portfolio transactions.

In the context of debt securities, we would consider the lack of price transparency to be the most significant issue in relation to trade execution. Although it is only one of many factors to be considered, price is clearly one of the most significant factors to be considered in measuring for best execution. Without detailed pricing information, or another source of comparable debt security information, the measurement and determination of best execution is more difficult and less demonstrable.

Question 7:

How should dealers in Canada monitor and measure the quality of executions received from foreign executing brokers?

Response:

To the extent possible, based on the availability of trading information, dealers in Canada should apply the same standards to measurement of trades by foreign executing brokers as they do when themselves executing trades in local markets. In such a scenario, the obligation to seek best execution falls, at first instance, on the Canadian dealer who has engaged the foreign executing dealer. At the present time, in order to meet its obligations, the Canadian dealer must apply the standards to which it is subject, as it will be held accountable on those standards by the client. On a going forward basis, to the extent the standards are more uniformly applied globally, foreign executing dealers will be subject to similar or consistent standards to those in other jurisdictions, and they will be measured more consistently by dealers in those jurisdictions. This should result in more consistency in the ability to measure and demonstrate execution quality.

Question 8:

Do you think that internalization of orders represents an impediment to obtaining best execution?

Response:

Any internalization of trades must still comply with the dealer's obligation of best execution. In the event trades are crossed, the dealer must take into account the requirements of both clients, both of whom are owed best execution. As long as the dealer discloses the fact it may internalize a trade, and as long as the internalization of orders does not reduce the amount of information available to the client to measure the quality of execution, the internalization should not by itself be an impediment to obtaining best execution.

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)?

Response:

Although it is not clear whether the phrase “OTC securities” as used in the Concept Paper includes fixed income securities, we submit that any improvement to the amount and quality of information available to dealers and their clients which would enhance their ability to measure and monitor the quality of the execution is appropriate. However a requirement to obtain multiple quotes for OTC securities may not advance this goal, and may in fact impede best execution. It is very likely that by the time a second quote (which happens to be less favourable) is obtained, the first (more favourable) quote would no longer be available.

We have to date not sufficiently studied the NASD fair pricing requirements, or their impact, in order to comment on their potential value to the Canadian marketplace.

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?

Response:

As noted earlier, the development of tracking and monitoring tools and standards in the listed equity realm is still very much developing. In those less transparent markets, such as the debt or unlisted equity markets, the development of tools and standards for tracking best execution is even earlier in its infancy. The process of development of any measurement tools should clearly take into account markets where there is little trade transparency.

B. Soft Dollars:

General Comments

Historically the use of soft dollars by investment managers to pay for certain goods and services has been permitted on the basis that the benefit of that use accrues to the funds and the investors in those funds, and not to the portfolio adviser. This is the foundation of OSC Policy 1.9 and Policy Statement Q-20 of the (now) Autorité des marchés financiers in Quebec. We believe this should remain the fundamental requirement for any soft dollar usage.

Investors are best served by a system that enables their investment managers to readily obtain a wide variety of high quality investment research and that encourages the development of a thriving independent research industry. In the current environment where execution and research goods and services are offered on a “bundled” basis with transaction services as well as on an “unbundled” basis, we believe soft dollars to be a valuable asset to mutual funds and their investors. In the absence of unbundling, it is

important to ensure a level playing field between providers of bundled research and transaction services and unbundled or independent research providers who rely almost entirely on soft dollars for compensation for their services.

We take issue with the proposition in the Concept Paper that soft dollars are “a barrier to best execution”. Soft dollars may increase the complexity of measurement of execution quality, and there are views that soft dollars create a conflict of interest providing the opportunity for a manager to favour its own interests, but these are simply factors to be considered in selecting executing dealers for portfolio transactions and issues that can be addressed adequately through enhanced transparency and disclosure. They should not be considered a fatal indictment of the soft dollars concept. Perceived problems with soft dollars, that are seized upon by those who would counsel complete elimination of soft dollars, are rarely actual problems, and are likely based on limited or inaccurate information. The benefits of soft dollars to mutual funds and their investors are typically discounted or entirely overlooked.

The ultimate solution to this issue may be to require a complete unbundling of research and transaction services, in other words to require “bundled” dealers to more clearly set out the component costs of services in commissions. This should assist investment funds generally to demonstrate quantitatively what impact, if any, soft dollar amounts have on best execution. Regulatory proposals in other jurisdictions such as the United States and the United Kingdom promote an increase in the disclosure of execution-only commissions within the dealer community and regulators have been narrowing the use of soft dollars for index and money market funds. We submit that as a longer-term goal, the CSA should obtain more quantitative information on all of the components comprising commissions before “best execution” and “soft dollar” issues can be properly assessed.

IFIC’s fundamental position is that in the absence of a complete unbundling of execution and related services, the availability of soft dollars to pay for investment decision-making services as permitted by OSC Policy 1.9 is a valuable asset for mutual funds and their investors. When requesting a “full-service” commission rate and a “bundled” commission rate, portfolio advisers often will be quoted the same rate. The difference is that in a bundled situation the dealer retains only a portion of the commission; the balance is used to pay for other services. In essence, there is no extra cost for the trade. Accordingly, in the absence of unbundling, portfolio advisers that refuse to take advantage of soft dollars that are made available to them may in fact be “leaving money on the table”, a result that is not in the best interests of the funds they are managing.

With bundling in place it is virtually impossible to accurately calculate the costs, effects and issues associated with soft dollars, and by extension, virtually impossible to fairly and reliably determine the appropriate policy direction and standards that should be applied to their use. The FSA, NASD and SEC are reviewing these issues and are steering broker/dealers towards improved transparency in the breakdown of costs and services contained in standard dealer commissions. We submit that to ensure a consistent result with the other jurisdictions, the CSA must also move in this direction and consider

the formulation of any policies on the foundation of factual information and not conjecture and assumption.

IFIC is concerned about the prevalence of inconsistency of usage of the term “soft dollars” and believes that much of the confusion and inaccuracy surrounding soft dollars results from the proliferation of inconsistent information and parlance in current usage. There have been statements that certain firms have stopped using, or have never used, soft dollars. However, it is usually the case that the firm does in fact use soft dollars, but limits that use to proprietary research. In our view even the Concept Paper uses inaccurate terminology. As an example, section 5(a) states “soft dollars refers to the practice by advisers of using commission dollars to pay for trading-related goods or services in addition to paying for trade execution.” We do not believe this definition accurately conveys the meaning of soft dollars, since soft dollars is not a practice, rather a term referring to the amount payable for goods or services in addition to trade execution. As well, “trading-related goods or services” does not accurately equate to the scope of goods and services permitted in OSC Policy 1.9, namely goods or services used for “investment decision-making services” and “order execution services”.

Another CSA regulation applicable to mutual funds, National Instrument 81-106, describes soft dollars as “... the quantifiable value of goods and services, beyond the amount attributed to order execution, received directly from the dealer executing the fund’s portfolio transactions, or from a third party”. While we do not necessarily endorse that “definition”, we believe that at the very least the usage of this term must be consistent among the CSA’s various legislative and regulatory pronouncements governing this area.

In addition, section 5(a) of the Concept Paper contains a sentence that reads “For clarity, we refer to the payment of third party services as soft dollar arrangements, and the services provided by a full-service dealer as bundled services”. With respect, we do not consider this to be accurate as both bundled and third-party payments can be soft dollar arrangements. IFIC’s Working Group (described below) is developing recommendations for definitions to promote consistency in the usage of these terms.

As with best execution, the CSA must, as a priority matter, adopt definitions of soft dollars concepts that are clear, concise and consistent with definitions that have been adopted or that are being developed in the other significant capital market jurisdictions around the world. Once everyone is working from a standardized definition any real abuse will be more readily determinable and the appropriate degree of regulation, if any, will be more apparent.

The mutual fund industry has been addressing soft dollars issues for some time. The Concept Paper cites some historical abuses in the use of soft dollar assets that typically involved incentives and directed brokerage to certain dealers distributing mutual funds. To address this, in 1996, IFIC released a Code of Sales Practices for the Mutual Fund Industry prohibiting many sales practices and incentives that could result in conflicts of

interest between investors and fund distributors, salespersons and fund managers. The IFIC Code was the basis for National Instrument 81-105 which is credited with the elimination of directed brokerage in Canada.

Since July 2004 an IFIC Working Group has been studying the current state of the art in the use of soft dollars by mutual funds, with a view to making recommendations for their use in light of the changing global regulatory environment. The Working Group is considering reports and proposals from various regulatory bodies including the Securities and Exchange Commission (“SEC”) and National Association of Securities Dealers (“NASD”) in the United States, the Financial Services Authority (“FSA”) in the U.K. and the Australian Securities and Investments Commission, as well as position papers issued by various entities such as the CFA Institute (formerly AIMR), the Mutual Fund Directors Forum, the Securities Industry Association, the Investment Company Institute and the Investment & Financial Services Association Limited.

The Working Group notes significant consistency in the recommendations published by most of these bodies, especially the NASD and the FSA. Those recommendations are, essentially, to continue to permit the use of soft dollars by portfolio managers, although such use should be more narrowly constrained than is the case today, and that this approach be applied to both order execution services and investment decision-making services or “research” (both proprietary and third-party). In its latest release, Consultation Paper 05/5 Bundled Brokerage and Soft Commission Arrangements: Proposed Rules, the FSA has proposed limiting investment managers’ use of dealing commission to the purchase of “execution” and “research services”, requiring such managers to disclose to their customers details as to how the commission payments have been spent and what services have been acquired, embedding in the commercial relationship between investment managers and brokers incentives to secure value for clients for what commission payments are spent on and promoting a more level playing field in the production of research⁵. The goal is to improve the accountability and transparency of soft dollar arrangements, while retaining a valuable asset for investment managers.

The NASD/FSA recommendations are of interest to the Working Group for possible recommendation for use in Canada. Given today’s global markets, we are aware of the necessity for consistent rules on use of soft dollar transactions among the major capital markets. This theme is confirmed in a recent SEC statement that it hopes to develop a set of soft dollar rules jointly with the FSA.

We also urge the adoption of a harmonized approach among the various types of investment funds to ensure the existence of a level playing field in the use of soft dollars and to maintain the competitiveness of mutual funds to other non-mutual fund investments, such as pension plans, brokerage products, segregated funds and hedge funds.

Partly to deal with the perception of conflict of interest, purchasers of execution services, including several Canadian fund managers, have entered into commission recapture arrangements. In these arrangements, in exchange for a portion (usually less than 20%) of the manager's execution business, a dealer will rebate a portion of its earned commission directly to the fund for which the trades were executed. Executing dealer selection is always made on a best execution basis. The structure might involve a third party administrator, such as the fund's custodian, to manage the flow of recaptured commissions, or the manager may do so internally. However in all cases the funds are directed to the funds and not to the manager. This is consistent with the foundation of permitted soft dollars usage, namely that the benefit must accrue to the funds and not the manager.

Answers to specific questions raised in the Concept Paper concerning soft dollars:

Question 11:

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

Response:

The submissions of our individual Members may contain descriptions of the particular measures each takes to ensure this consistency.

On a more general level, as a pre-condition to registration, and on a regular basis thereafter, investment counsel/portfolio managers are required to maintain a Practices and Procedures Manual that must contain, among other items, provisions concerning trading and brokerage. On this topic the manual must provide guidelines on the selection of brokers, fairness in allocation of investment opportunities among client accounts, obtaining best price and best execution for clients, executing trades in a timely manner and in accordance with the portfolio manager's instructions, monitoring and resolving failed trades and trading errors, as well as guidelines on soft dollar arrangements with brokers.

As stated above, fund managers are permitted to make use of soft dollars in accordance with OSC Policy 1.9. In the absence of complete unbundling, fund managers' refusal to make use of them may be a breach of their duty to act honestly, in good faith and in the best interests of the mutual fund, exercising the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances. So long as the use of such arrangements enures to the benefit of the funds the manager is acting in a manner consistent with its duty of care.

Question 12:

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

Response:

As we noted in our general comments concerning soft dollars, and the response to Question 11, in the current environment soft dollars is an asset that is available to mutual funds. Their elimination would result in fund managers leaving assets on the table, to the economic detriment of their funds and investors. This is a poorly understood benefit that is always overlooked in the commentaries. A benefit which has already been mentioned is that independent research firms rely on soft dollars for the majority of their revenue. Elimination of this revenue stream would threaten the continued availability of such research, as such firms cannot effectively compete for business with proprietary research firms. We have also heard concerns that permitting the use of soft dollars can lead to higher fund costs and excessive portfolio turnover. We would submit that the correct way to address such concerns is not to eliminate the availability of soft dollars, which offers many tangible benefits and only perceived or possible problems, but rather to ensure an effective monitoring and disclosure system.

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?

Response:

We agree that it should remain acceptable to pay for certain goods and services using soft dollars. OSC Policy 1.9 currently permits such use with respect to order execution services and investment decision-making services. While we are still studying the available alternatives, we see merit in the U.K. and U.S. proposals, namely to limit such goods and services to execution and research, where research is defined to permit that developed both by third-parties to the executing dealer and that which is proprietary to the executing dealer.

IFIC’s Working Group is still considering the appropriate definitions and scope of use of soft dollars which it could recommend for use in Canada, among other issues which attach to such a recommendation.

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?

Response:

We note that each of the disclosure obligations cited in this question seeks disclosure of specific items of information for specific and different purposes. We have no objection to better disclosure in order to address issues of transparency surrounding the use of soft dollars, however more disclosure does not always equal better disclosure. IFIC's Working Group is still studying what would be the appropriate degree of disclosure that balances the desire for greater transparency with the desire to provide useful and informative data. Efforts must be made to ensure the information that is appropriate to be disclosed, and the location of that disclosure, is helpful to investors and appropriately meets the objective and purpose of the disclosure. As well, we must be careful to ensure that "apples to apples" information is provided, otherwise there is potential for even greater confusion and misinformation about soft dollars than at present. For instance, proprietary research must be valued in order to be disclosed, and it must be disclosed if it is to be treated the same as third-party research.

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)?*

Response:

In the absence of the unbundling of commissions, portfolio advisers are only able to negotiate with the executing dealers based on the information that is made available. Portfolio advisers that require an agency-only trade, that is highly automated, will generally be aware that the quoted commission is pure execution commission. However, for any other trade, typically a portfolio adviser is quoted the same commission rate whether it is quoted on a bundled or full-service trade basis. Accordingly, as a practical matter, without unbundling it is very difficult for a manager to allocate or split out the commission amount into a pure execution component and a "soft" component. To the extent such costs are to be allocated among funds, managers will do so on an equitable basis, using appropriate criteria.

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?

Response:

It is a GAAP requirement that commission costs be accounted for as an addition to the purchase price, or subtracted from the proceeds of disposition, of portfolio securities, on the basis that such costs are a capital item and not an income item. Our understanding is that only a small portion of commissions represents soft dollar costs.

In theory the investment decision-making services portion of commission payments should be accounted for as an operating expense, however only if this portion can be reliably measured or estimated, including the cost of proprietary research. Given that the cost of proprietary research cannot currently be so measured or estimated, and given that there cannot be different accounting treatment for such amounts as compared to third-party research costs, these amounts are treated in both cases as capital items.

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”?

Response:

No, we maintain that the MER should be based only on expenses that are recognized in the audited financial statements. We refer to our response to Question 16 above as to the reasoning behind accounting for commissions, including investment decision-making services, as capital items. We note as well that National Instrument 81-106 introduces the concept of the “trading expense ratio”, where total commissions paid are disclosed as a percentage of the average fund assets. This provides additional detail on the commission amounts paid for funds’ portfolio security transactions.

Question 18:

Should directed brokerage or commission recapture arrangements be limited or prohibited?

Response:

As discussed in our general comments, directed brokerage as defined in NI 81-105 is already sufficiently regulated. There is no indication of any abuses in that area – a fact that was confirmed during the informal discussions the CSA had with market participants in its groundwork to the Concept Paper. However, we would reiterate our concerns that, on the issue of directed brokerage, there should be a level playing field among the various types of investment funds offered to the public. Although NI 81-105 regulates this practice in the mutual fund industry, no similar restrictions exist in the pension and insurance realms. If this practice is deemed unacceptable for one type of investment fund, it should be considered unacceptable for all investment funds.

In its discussion of commission recapture, the Concept Paper paints this practice in a rather negative light, suggesting that the portfolio adviser has no control over the selection of executing dealer, the commission paid and the beneficiary of the recaptured amount.

As noted earlier, the commission recapture arrangements with which our Members are familiar work as follows: The portfolio adviser's trader selects, on a best execution basis, the dealer that is to conduct each portfolio trade. The trader selects from a list of "approved" dealers that have earned their place on the list based on their demonstrated execution abilities. The fund manager determines the volume of transactions that each listed dealer is able to process. In each case the manager also negotiates directly with that selected dealer the best commission rate net of recapture to be paid. An intermediary (often the fund's custodian) may be involved to administer the transactions and remittance of the recapture amount to the funds, although some fund managers perform this administration internally. In either case due diligence on the eligible dealers, and best execution monitoring of those dealers, is performed and in all cases, the recapture amounts are remitted directly to the funds, and do not enter the accounts of the fund manager.

We believe that in the current environment commission recapture represents the first step to a more unbundled world.

Question 19:

Should disclosure be required for directed brokerage or commission recapture arrangements?

Response:

On the basis that directed brokerage (as defined in NI 81-105) is not permitted pursuant to that Instrument, there is no need for disclosure of such arrangements. We agree in principle that there should be disclosure for commission recapture arrangements. As noted earlier, IFIC's Working Group is still studying the appropriate degree and location

of disclosure concerning all aspects of soft dollars, to ensure the disclosure provides value to investors and that the objective and purpose of the disclosure are appropriately met.

Question 20:

Would any of these initiatives be helpful in Canada?

Response:

IFIC's Working Group is currently reviewing and considering each of the proposals and initiatives underway in these jurisdictions. The objective is to determine the state of the art at present and to make recommendations for the use of soft dollars by IFIC members in light of the global regulatory environment. In this regard we are currently considering the value and potential impact of these initiatives if implemented in Canada.

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We would be pleased to discuss any of our comments with you further at your request. Please contact Ralf Hensel, Senior Counsel, at (416) 363-2150, ext. 254, or at rhensel@ific.ca, if you should have any questions or require additional information.

Yours very truly

"Original signed by Thomas A. Hockin"

Hon. Thomas A. Hockin
President & CEO

¹ CESR's Draft Technical Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments, Second Consultation Paper, March 2005, Article 21.1.

² CFA Institute Trade Management Guidelines, page 3

³ Ibid, Definition of best execution, Appendix A.

⁴ CSA Staff Notice 23-302, Joint Regulatory Notice – Electronic Audit Trail Initiative (TREATS), issued April 15, 2005.

⁵ Financial Services Authority Consultation Paper 05/5 Bundled brokerage and soft commission arrangements: proposed rules, published March 2005.