THE INVESTMENT FUNDS INSTITUTE OF CANADA
L'INSTITUT DES FONDS D'INVESTISSEMENT DU CANADA
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British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Securities Commission
Manitoba Securities Commission
Ontario Securities Commission
New Brunswick Securities Commission
Securities Office, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Registrar of Securities, Northwest Territories
Registrar of Securities, Nunavut
Registrar of Securities, Yukon Territory

c/o John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
Suite 1903, Box 55
Toronto, Ontario, M5H 3S8

Madame Anne-Marie Beaudoin
Directrice du secrétariat
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, Tour de la Bourse
Montreal, Quebec, H4Z 1G3

Dear Sirs/Mesdames:

Re: Proposed NI 23-102 *Use of Client Brokerage Commissions as Payment for Order Execution Services or Research ("Soft Dollar" Arrangements)*

We are writing to provide the comments of the Members of The Investment Funds Institute of Canada ("IFIC")[1] on the Notice, Proposed National Instrument 23-102 *Use of*

[1] Founded in 1962, IFIC is the national association of the Canadian investment funds industry. Membership comprises mutual fund management companies, retail distributors and affiliates from the

Client Brokerage Commissions as Payment for Order Execution Services or Research ("Soft Dollar" Arrangements) and the accompanying draft Companion Policy, published for public comment by the Canadian Securities Administrators ("CSA") on July 21, 2006 (respectively, the "Notice", "Proposed Instrument" and "Proposed Policy"). We understand that several of our Members have also submitted individual comment letters.

We have submitted comments on the precursor to the Proposed Instrument, Concept Paper 23-402, *Best Execution and Soft Dollar Arrangements* (the "Concept Paper") on June 9, 2005. We also met with representatives of the Ontario Securities Commission ("OSC") on October 11, 2006, to discuss the industry's preliminary thoughts on the Proposed Instrument. At the encouragement of the OSC representatives in attendance at that meeting, we have included those issues in this letter.

General Comments:

We support the CSA's decision to continue to permit brokerage commissions to be used, subject to limitations, to purchase order execution goods and services, and research. We support the CSA's decision to continue to allow both proprietary and third-party goods and services to be so purchased. We support the application of the Proposed Instrument to capital markets participants beyond investment funds as this moves the industry a step closer towards a level playing field where consistent rules apply to similar market participants, helping to eliminate competitive disadvantages. We also support the overall policy objective of a nationally-harmonized and internationally-harmonized rule offering more effective disclosure of use of commission dollars, as an expense.

However, our Members have several, significant concerns with the Proposed Instrument. These concerns include the lack of harmonization achieved with both foreign jurisdictions and other products in the domestic market; duplication with current requirements; unclear, detailed and complex disclosure requirements; and the failure of the Proposed Instrument to impose an obligation on dealers to provide information. These concerns are summarized below and further details are provided in the attached Appendix.

Harmonization with foreign jurisdictions: We have emphasized the need for a Canadian approach to soft dollars that is consistent with approaches taken in other jurisdictions, particularly U.S.A. and the U.K. This is particularly important in light of the high volume of trading carried on by Canadian mutual funds in these jurisdictions, and is essential to allow Canada's mutual fund and other advisers to attract international clients and otherwise compete in the international marketplace. Similarly, differing

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legal, accounting and other professions from across Canada, who work in an open, consultative process to ensure all views are considered and met. Members' assets under administration – the amount Canadians have invested in the mutual fund industry – currently stand at well over $550 billion.

regimes among international jurisdictions increases the compliance burden on Canadian advisers who use international sub-advisers, thus increasing costs to Canadian investors; and may, in certain circumstances, limit access to established international sub-advisers who do not wish to amend their own practices to conform to a different regime, solely for the purpose of servicing relatively small Canadian clients.

The Proposed Instrument deviates from approaches adopted in these foreign jurisdictions. Key examples of such deviations include: the application of the Proposed Instrument to fixed income transactions and other securities trades without fully disclosed commissions or independent pricing mechanisms; and differences in the guidance relating to "permitted" goods, services and research. These create compliance difficulties for Canadian advisers using foreign sub-advisers who will not be accustomed to providing this disclosure (and may not be able to do so), and for Canadian advisers using foreign dealers who may not understand the differences when providing such services. Again, these differences risk placing Canadian advisers at a competitive disadvantage to their international colleagues.

Harmonization with other products: The Proposed Instrument does not apply to *all* sponsors of similar investment products. Segregated funds, for example, are not covered. This places Canadian mutual funds at a competitive disadvantage.

Duplication: The Proposed Instrument does not consider the infrastructure already in place and current regulatory requirements, such as subpara. 3.6(1)(3)(b) of National Instrument 81 – 106 ("NI 81-106") which requires disclosure of the estimated soft dollar portion of commissions paid by Canadian mutual funds. Recent industry experience indicates that compliance with this relatively new requirement requires significant time and resources. The Proposed Instrument will impose additional requirements, added complexity and cost burden on mutual fund managers uniquely.

Detailed and Complex Disclosure requirements: The rule requires very detailed information to be collected, tracked and disclosed. It is also not clear to us who is expected to receive this disclosure. We do not believe the new information will assist (and may mislead) individual investors in Canadian mutual funds.

In any event, to accomplish this task a new and costly system-build will be required. We believe the cost-benefit analysis accompanying the Proposed Instrument, which we note appears to include salary costs only, significantly understates the cost to the industry that will be required for compliance.

No obligation on dealers to provide needed information: The Proposed Instrument does not impose a positive obligation on dealers to deliver commission information to advisers for transactions where commission amounts are not clearly stated nor easily determinable by the adviser. Thus responsibility for compliance with the disclosure aspects of the Proposed Instrument (determining, tracking, calculating and disclosing the detailed information set out in Part 4) falls to advisers. In the absence of limiting the

application of the Proposed Instrument to transactions with fully disclosed commissions or independent pricing mechanisms, as would be consistent with U.S. and U.K. rules, many advisers will find it difficult to obtain the necessary information.

A detailed discussion of our concerns follows in the attached Appendix. Note also that we have not responded to the specific questions posed in the Notice to the Proposed Instrument as we believe our detailed comments respond to many of these questions.

We thank you providing our Members with the opportunity to comment on this important initiative. We look forward to working with the CSA to produce a soft dollar disclosure rule that will provide true value to investors.

Please contact the undersigned directly or Ralf Hensel, Senior Counsel, at (416) 309 - 2314 or rhensel@ific.ca, should you have any questions or wish to discuss these comments.

Yours truly,

THE INVESTMENT FUNDS INSTITUTE OF CANADA

"*Original signed by Joanne De Laurentiis*"

By: Joanne De Laurentiis
President & Chief Executive Officer

JD/jwm

Encls.

Appendix

The Investment Funds Institute of Canada

Detailed Comments on Proposed NI 23-102

(NOTE: These comments are organized using the paragraph headings set out in the Notice relating to the Proposed Instrument (the "Notice") for ease of reference.)

Application of the Proposed Instrument

Harmonization among Investment vehicles: The Proposed Instrument applies broadly, but does not apply to all sponsors of similar investment products. Life insurance segregated funds, for example, will not incur the significant compliance costs that we believe will be associated with the Proposed Instrument. We encourage the CSA to work with the Joint Forum of Financial Market Regulators to ensure consistent rules are adopted among similar investment products so that: (1) opportunities for "regulatory arbitrage" are eliminated (*viz* advisers and dealers are not motivated to create and offer one investment vehicle over another simply by virtue of ease of compliance; (2) investors receive consistent levels of disclosure and protection; and (3) investors and analysts are able to make comparisons across functionally-alike products.

The Proposed Instrument does not recognize the many disclosure and conflict of interest regulations already in place for investment funds. Paragraph 3.6(1)(3) of NI 81-106, for example, requires that the notes to the financial statements of a fund disclose:

> (a) total commissions and other transaction costs paid or payable to dealers by the fund for its portfolio transactions during the period reported upon; and
>
> (b) to the extent the amount is ascertainable, separate disclosure of the soft dollar portion of these payments, where the soft dollar portion is the amount paid or payable for goods and services other than order execution.

Section 2.6 of the Companion Policy to NI 81 – 106 *Disclosure of Soft Dollars* states that the notes to the financial statements of an investment fund must contain disclosure of soft dollar amounts when such amounts are ascertainable. When calculating these amounts, funds should include 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.

These financial statements are provided to the individual investors of each fund. This suggests that in the investment fund world investors are already receiving the appropriate amount of information about the fund's soft dollar activity, including the dollar value of goods and services acquired, other than order execution. In addition the notes provide disclosure of the total commissions paid, making apparent the relative size of the fund's

soft dollar transactions to its overall portfolio transaction activity. Furthermore, NI 81-106 also requires disclosure as to a fund's use of commission dollars (to the extent ascertainable) to be included in the Management Report of Fund Performance which is made available to investors semi-annually.

Similar disclosure to investors is also required in a fund's Annual Information Form by National Instrument 81 – 101 ("NI 81-101"). Pursuant to subss. 10.4(1) & (2) of NI 81-101F2, mutual funds must provide general information on brokerage arrangements, including the method or criteria used in allocating brokerage business to dealers and firms providing research services, as well as disclosure relating to service providers including whether those services were paid for through brokerage commissions. As a result, investors already have access to information on a fund's use of commission dollars.

The Proposed Instrument also does not seem take into account the rules and requirements concerning potential conflicts of interest applicable to Canadian investment funds pursuant to National Instrument 81-107 ("NI 81 – 107") (discussed below).

Imposition of the requirements in the Proposed Instrument, in addition to these pre-existing requirements, will result in regulatory duplication for investment fund managers, which will increase costs and create a competitive disadvantage for them. Investment fund investors will receive no additional benefit from the more detailed information proposed to be delivered under the Proposed Instrument. In fact, the degree of detail proposed for this disclosure may well operate to decrease any or eliminate any additional value as investors will not understand it and may simply ignore it completely.[2]

International Harmonization: The Proposed Instrument applies to advisers and registered dealers in relation to transactions where brokerage commissions have been charged by a dealer. These include fixed income transactions and other transactions (such as principal traded securities) where commission amounts or other fees are included in the price of such trades and are not explicitly disclosed. The Notice acknowledges that similar rules promulgated by the U.S. Securities and Exchange Commission ("SEC") and the U.K. Financial Services Authority ("FSA") are restricted to trades in securities where commissions payable are, in effect, explicitly disclosed, but provides no explanation for the different Canadian approach. This undercuts achievement of the harmonization objective of the Proposed Instrument. Accordingly, we submit that the Proposed Instrument should be amended to restrict its application to transactions where

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[2] A recent study conducted by IFIC indicates that Canadian mutual fund investors overwhelmingly prefer brevity when it comes to disclosure about their mutual funds. Source: *Canadian Investors' Perceptions of Mutual Funds and the Mutual Fund Industry's 2006* (Report prepared for IFIC by Pollara Inc., 2006)

commissions are fully disclosed by the dealer or there is an independent pricing mechanism for the following reasons:

(1) The Proposed Instrument does not impose a positive obligation on dealers (Canadian or otherwise) to provide commission information to advisers. Requiring advisers to disclose commissions or other fees paid on transactions (discussed above) where the commission amount is neither explicitly disclosed nor easily determinable by the adviser, without a corresponding obligation to provide such information on the dealer who provides the services (the party that determines and receives the commission and/or fee) places an extremely heavy burden on advisers which will result in higher costs, increased errors, reduced competitiveness and international disadvantage.

(2) The fees imbedded in fixed income securities and other principal traded securities are difficult to separate from the many factors that combine to result in the final price. Accordingly, any data regarding such fees, absent a requirement for dealers to disclose to advisers, would be estimates at best. There is an argument to be made that the increased costs associated with capturing, tracking and reporting this data are not warranted given its fundamental imprecision.

(3) Financial markets are becoming increasingly global and the Canadian market remains a very small component.[3] Canadian investment fund managers regularly execute portfolio trades through U.K. or U.S. dealers. The number of these trades has increased dramatically given the recent removal of foreign content restrictions on registered retirement savings vehicles. We expect that this increase will continue.

(4) Increased holdings of foreign securities by Canadian mutual funds will result in ever-increasing management of investment portfolios of Canadian mutual funds by non-Canadian sub-advisers. Current and proposed CSA rules require Canadian advisers to ensure compliance by their sub-advisers with Canadian rules. Accordingly, Canadian "soft dollar" application and tracking requirements that are inconsistent with the rules in those other jurisdictions will increase the compliance burden and costs borne by Canadian advisers as well as increasing the likelihood of inadvertent errors. These additional costs will place Canadian advisers subject to the Proposed Instrument at a competitive disadvantage within Canada, as against advisers not subject to the Proposed Instrument, and as against advisers from other jurisdictions who may compete with Canadian advisers internationally.

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[3] As at June 30, 2006, Canadian mutual funds represented only 2.7 *percent* of mutual fund assets managed by the members of the International Investment Funds Association ("IIFA") Source: IIFA International Data Exchange, 2006 Q2.

(5) Canadian “soft dollar” application and tracking requirements that are inconsistent with the rules in other, major jurisdictions will increase the compliance burden and costs born by foreign advisers and dealers who do business with Canadian advisers as well as increasing the likelihood of inadvertent errors. In some cases, it may be very difficult or virtually impossible for foreign firms to comply with Canadian rules. In either event, these firms may elect that dealing with Canadian firms is simply more trouble than it is worth. This will effectively reduce access by Canadian investors to necessary international investment expertise and services at a time of increased need for such services and expertise.

The Framework for Client Brokerage Commission Practices

We believe that the proposed obligation on advisers to ensure that order execution services and research purchased with brokerage commissions benefits their clients and adds value to their investment or trading decisions, together with the proposed obligation to ensure that the amounts of brokerage commissions paid is reasonable in relation to the value of the services or research received are consistent with a fund manager’s statutory duty of care to investors set out in subs. 116 (1) of the *Securities Act* (Ontario) and in similar provisions in effect in other CSA jurisdictions. Our Members that use soft dollars today have in place policies and procedures that ensure (and document) that the benefits obtained through use of soft dollars accrue to the benefit of clients, add value, and are obtained at reasonable cost.

However, there is an inconsistency between the Notice and Proposed Instrument that, in our view, requires clarification:

The Notice appears to extend the requirements of subss. 3.1(2) and 4.1(2) for adequate policies and procedures regarding a fair allocation of goods and services, to require a direct “one for one” allocation of commissions to benefit received. The text of the Proposed Instrument suggests a more general connection of all commissions generated by clients of the adviser to benefits received by clients of the adviser. We submit that the latter interpretation is preferable. A precise, one-to-one connection may be impossible to achieve for a typical investment fund adviser responsible for the management of several different funds, as each fund would have different trading profiles and patterns, incurring different commission amounts and generating differing goods and services credits. On the benefit side, research obtained by an adviser may add value to the decisions being made with respect to several funds. In addition, commissions incurred in a particular year (generating credits for permitted goods and services) may not be used by an adviser until a future year, making a one-to-one connection even more tenuous, and the proposed disclosure to clients of this information misleading.

Definitions of Order Execution Services and Research

We are generally supportive of the guidance regarding the meaning of "order execution services" and "research" that is contained in the Proposed Instrument and Proposed Companion Policy.

However, the detailed guidance on what constitutes order execution services and research is not sufficiently consistent with the detailed lists in place in other jurisdictions, particularly the U.S. and U.K. As noted above, inconsistencies between Canadian standards and those in effect in major foreign jurisdictions where Canadians do business and look to hire expertise cause significant compliance problems for Canadian advisers as well as increased costs and other competitive disadvantages. These inconsistencies also undercut the stated CSA objective of a reasonably harmonized set of rules with other jurisdictions.

Examples of these differences include general statements in the documents that exclude raw market data and publicly available information from permitted research.
"Raw market data" for example, is permitted, pursuant to subs. 3.2(3) of the Proposed Policy, to the extent it assists in the execution of orders, but excluded as "research". This position is consistent with that adopted by the FSA, but not consistent with the position taken by the SEC. We submit that, given the close ties between Canada and the U.S., that it would be more practical to follow the U.S. approach in this regard. In the alternative, it should be made clear that if raw market data does assist in the execution of orders, such data can be acquired under the heading of "order execution services", but would not qualify under the "research" heading.

We also suggest that further clarification is required of the phrase "publicly-available information or publications" as used in the list of non-permitted goods and services in section 3.5 of the Proposed Policy. Many very specific research publications that meet the criteria for research in all other respects can be considered publicly-available simply by virtue of their distribution to more than one adviser. Consistent with the SEC's guidance, we believe some measure of materiality is required as to the scope of public availability to disqualify research on this basis.

We understand that many of the individual submissions made by our Members may discuss other specific issues with differences in permitted goods and services.

Disclosure

Intended Recipients: Section 4.1(1) of the Proposed Instrument requires an adviser to provide the mandated disclosure to each of its "clients." This term is not defined. In most cases, the principal clients of an adviser who is an investment fund manager will be the funds themselves though some may also serve individual investors in managed accounts or institutional investors.

Where a mutual fund is the "client", the fund is most commonly established as a trust, and the manager is typically the trustee as well as the adviser for the fund. Unlike in the U.S. (and with the exception of Canadian corporate-structure funds which are few in number) there is no separate fund board of directors or other entity that could properly be considered the adviser's "client". Accordingly, the Proposed Instrument would appear to require the disclosure by the manager as adviser to itself as trustee – an anomalous result which clearly was not intended. We raised the meaning of the term "client" at our October 11 meeting with OSC staff who acknowledged that clarification was needed.

We do not support the provision of the detailed disclosure referred to in the Proposed Instrument to individual investors in investment funds. We believe that the amount of complex and detailed information proposed to be provided would be of little value to investors and of no value whatsoever in the absence of additional, explanatory detail on best execution and other factors which led to the commission amounts disclosed. Similarly, any benefit accruing to an investor sophisticated enough to find such information useful, will likewise be more than outweighed by the costs incurred by the adviser to produce and deliver it.

We note that the SEC is currently considering additional requirements for disclosure of use of commissions. Our colleagues in the U.S. have advised that these proposals would require disclosure to the board of directors of an investment company, and not to individual shareholders.

While fund structures in Canada differ somewhat from those in the U.S., we would be less concerned if, for purposes of the disclosure in Part 4 of the Proposed Instrument, "client" was defined to mean the independent review committee ("IRC") that Canadian mutual funds are now required to put in place pursuant to National Instrument 81 – 107. IRCs are mandated to review a fund's conflict of interest matters. A fund manager is required to present to the fund's IRC information about the manager's soft dollar practices, as a potential conflict of interest matter. Typically a manager would submit its soft dollar policies and procedures for approval by its IRC, with subsequent regular reports to demonstrate compliance with those policies. IFIC manager Members with pre-existing IRCs have already been providing such disclosure to their IRCs, in some cases for many years. Significantly, we are advised by our Members that these IRCs (comprising knowledgeable professionals) have not found it necessary to request the degree of detailed information that the Proposed Instrument would require be provided to clients (who, if individual investors, likely would have no understanding at all of soft dollar concepts).

Amount and Type of Disclosure: The increased disclosure requirements set out in the Proposed Instrument are intended to:

(a) provide investors with more information about their adviser's use of soft dollar commissions;
(b) increase confidence that commissions are ultimately benefiting those that pay them.

We support these worthy objectives but believe that the Proposed Instrument requires a degree of disclosure that is far in excess of what is reasonable and necessary to achieve them. The amount of detailed data required will not be of any value to clients – whether such clients are individual investors or the funds themselves.

We submit that the current disclosure required under NI 81 – 106 and NI 81 - 101, as discussed above, is adequate to achieve the stated objectives. In the alternative, a narrative approach, explaining an adviser's soft dollar policies and practices, would provide useful disclosure that would benefit readers in assessing the adviser's use of commissions to a far greater extent than disclosure of the more granular data proposed under the Proposed Instrument. In addition, we note that the Proposed Policy (in s.3.4) requires the maintenance of adequate books and records including records relating to allocation of goods and services paid for with soft dollars to ensure commissions are not used to pay for components of mixed use items that do not benefit clients. These detailed records could supplement the disclosure required under NI 81 – 106 to provide regulators with complete information for compliance review purposes.

In the alternative, we submit that the Level 1 disclosure described in the U.K. Investment Management Association's *Pension Fund Disclosure Code* would provide an adequate and helpful amount of disclosure to investors that meets the CSA's stated objective, without requiring the creation of costly mechanisms to track and produce the detailed disclosures that are intended in the Proposed Instrument. This disclosure comprises a narrative description of the adviser's policies and procedures relating to management of expenses incurred on behalf of clients.

Cost Benefit Analysis

Our Members have advised that the cost-benefit analysis ("CBA") that accompanies the Proposed Instrument significantly understates the effort and cost of the measures necessary to implement the proposals in the Proposed Instrument.[4]

[4] The CBA provided in the notice includes no expenses in respect of systems modifications that may be required to capture, manipulate and report the necessary for the proposed disclosure requirements. This is a significant omission. Amounts cited in respect of legal counsel and senior management are also somewhat understated. The *2006 Mutual Fund Industry Compensation Survey* prepared for IFIC Members by HayGroup indicates, for example, that 2006 median salary and bonus for legal counsel at a mutual fund manager firm would be $156,000, a chief compliance officer, $182,000 and a VP/General Counsel $274,000. It is unlikely that all of these individuals would be involved in the design approval and implementation of the new data collection, reporting and compliance regime that would be required to implement the Proposed Instrument.

The procedures and staff resources that will be required to track all goods and services and to prepare the data analysis required for the disclosure will cost significantly more than estimated.

One of our larger manager Members has roughly estimated its own costs of implementation could be over $1.5 million - almost the total cost estimated by the CBA for the entire industry - even before factoring in this Member's costs for the necessary human resources to implement the system that would be required by the Proposed Instrument. The cost to the fund industry as a whole, therefore, will be many orders of magnitude higher than estimated in the CBA for the entire adviser and registered dealer community. Ultimately this will add another layer of cost to the investor without corresponding benefits.