Appendix A
Concept paper 23-402 Best execution and soft dollar arrangements
Summary of comments

I. Response to questions

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?

Some commenters believed that current requirements were sufficient and provided the necessary structure in which all participants have a consistent and reliable framework for best execution. Other commenters, however, believed that the current requirements are too narrow as the obligation focuses on "best price" and price is just one element in overall execution quality.

Some commenters believed that the CSA should define the roles and responsibilities of the participants responsible for best execution. One commenter noted that it would be helpful to market participants to have consistent definitions of the elements of best execution as well as guidance on how to measure and monitor each element.

One commenter noted that investors in the equity markets more easily understand application of the current requirements for best execution; however, in fixed income markets, application of the best execution concept is broad and very often a function of the role the investor is playing in a trade. Another commenter noted that best execution should apply to the secondary debt markets and may also be appropriate for new issue markets (for example, unequal treatment in allocation of new issues should not be acceptable). The commenter was concerned about the lack of clear and specific IDA rules for the unlisted debt securities market and believed that the CSA and/or the IDA should adopt clear best execution rules for the fixed income market that establish clearly that they apply to principal transactions as well as agency transactions and that the pricing and offerings of all ATSs providing a fixed income marketplace should be reviewed before transacting as principal with clients.

One commenter noted that there appears to be an assumption that orders are facilitated in some way by a dealer, but the growing importance of direct market access systems should be acknowledged as well. The distinction of who places the order is very important when considering the next steps in regulation. The CSA should ensure that whatever regulatory changes are contemplated with regard to best execution should consider the evolution of markets and the different roles played under different market structures. Several commenters emphasized that best execution is a process that involves many elements.

The majority of commenters believed that investor education generally would be helpful. A few commenters did not think that education programs would be useful.

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?

The majority of commenters agreed that there should not be more prescriptive rules but best execution should be monitored through internal processes. One commenter noted that

prescriptive rules, while potentially desirable, would be impractical to administer as what constitutes best execution differs from order to order and will depend upon the market conditions at the time the order is made coupled with the needs and goals of the client. One commenter was not opposed to more prescriptive rules but expressed concern that these rules might be too narrowly defined and emphasized that any rules should focus on ensuring that information and processes are in place that can satisfy the need to demonstrate best execution in each particular circumstance. Another commenter suggested that the adviser's obligation to have processes in place for best execution should be articulated in a rule which should be designed from a "principles" based approach so that each adviser could tailor it to applicable operations. The commenter also noted that marketplaces should also be required to establish and enforce policies and procedures that ensure that they aid in the process and not hinder it.

One commenter noted that it would be impossible for a marketplace to take on a burden of best execution, which involves a choice of execution venue and an evaluation of trading opportunities across marketplaces.

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

Many commenters believed that the main elements of best execution were reflected. Some commenters suggested the following elements should be considered: client's instructions, liquidity, market impact, willingness to act as principal, order size, settlement, depth of market for a security, quality and reliability of price quotes, soft dollar arrangements, adverse price movements, risk.

Some commenters emphasized that best execution is about more than best price and should be seen as an outcome of a process and not an unconditional standard to be implemented on a trade-by-trade basis.

One commenter noted that it was important to discuss impediments to achieving best execution, which may be insignificant for small orders but become significant obstacles for institutional investors who must execute orders larger than the size of the best bid or offer (eg., trade-through rule, different market microstructures and derivatives-related rules).

One commenter noted 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.

Question 4: If audit trail information is not in easily-accessible form, how is the information used to measure execution quality? Is there other information that provides useful measurement?

Some commenters believed that if audit trail is not easily accessible in electronic form, it was difficult to measure execution quality. A few commenters noted that, even if easily accessible, audit trail would not capture all aspects needed to measure best execution. Some commenters believed that it is essential that there be an audit trail that is in an easily accessible format. One commenter noted that either an electronic audit trail system or a manual system is appropriate to measure execution quality if it yields the necessary audit information to permit this determination. Some commenters noted it is possible to test execution quality based on information not maintained in electronic form but emphasized that transparency of information

was an issue. Some commenters believed that an industry standard should not be applied to each organization to measure execution quality.

Some commenters suggested other information that provides useful measurement: the market close and overall performance of the equity over the trading period, “implementation shortfall” (the difference between the expected execution cost and the actual execution cost). It was noted that “analytics” services available in some larger markets are not feasible in Canada due to the limited breadth and depth of the market. One commenter suggested that periodic audit work by statutory auditors and internal audit staff should be used to ensure transaction efficacy.

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?

Five commenters generally agreed with the suggested description of best execution. One commenter believed that the process of “seeking to achieve this best net result and not necessarily by meeting an absolute standard” was appropriate. One commenter agreed with the definition but suggested that clarification of the meaning of “best net result” should be provided. One commenter noted that the proposed description emphasizing process was appropriate and thought that the fact that specific elements are expressly stated adds clarity. It was also recommended that any other relevant material factors be included in the definition for clarity.

Two commenters were concerned with the phrase “in light of the client’s stated investment objectives” and thought that this might shift the focus from best execution as a matter relating to the efficient execution of specific transactions and could broaden the concept to include the assessment of the merits of the transaction in relation to the stated investment objectives.

One commenter believed that the CSA should clearly establish the best execution obligation as the primary obligation to which all other obligations (best price, obligation to the marketplace, trade through) are secondary. It was noted that, in practice, this could be achieved by establishing an opt-out for institutions on best price/trade-through obligations. Another commenter noted that the CSA should provide additional clarification of the application of best execution obligations in situations where such obligations conflict with other regulatory obligations such as trade-through obligations.

A few commenters believed that the focus of the definition should be on best execution as a process. One commenter noted that the proposed description implies that best execution is an outcome.

One commenter suggested the following definition: “a process which results in the lowest total transaction cost for the client”. Another commenter stated that there is more benefit in the definition outlined in the CFA guidelines that define best execution as the trading process that firms apply that seek to maximize the value of a client’s portfolio within the client’s stated objectives and constraints, particularly because consistent rules would be beneficial. It was also noted that it has a greater focus on the process because it includes the investment decision-making process. One commenter suggested the SEC definition that “the money manager must execute securities transactions for clients in such a manner that the client’s total cost or proceeds in each transaction is the most favorable under the circumstances” states the obligation of both the money manager and the broker. It was also stated that, without a distinct definition of best execution, it is impossible for fund administrators/clients and regulators to determine whether abuses exist.

One commenter believed that the regulator's role should not be to unilaterally impose a standard definition that applies universally to all participants.

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?

(a) Listed equities – One commenter noted that trades in Canadian-only and inter-listed equities raise the least number of issues. Two commenters noted that the trading in the "upstairs market" has an impact on the ability to obtain best execution. One commenter noted that trading foreign securities involves higher commissions and currency conversion. Another commenter noted that there are issues with respect to foreign-listed equities around the availability and quality of information which make assessment of best execution difficult. One commented stated that the most significant issues impacting execution quality for listed equities are: depth in liquidity; trading rules that constrain the free flow of capital between competing marketplaces; the pre-disposition of SROs to preserve the status quo either by conscious effort due to their structure or the creation of excessive or unnecessary rules which inhibit competition. One commenter believed that as long as investors have price protection and a market environment that provides liquidity and transparency, there are no significant barriers to trading listed Canadian-only securities. Another commenter noted that the quality of execution for equity securities is adversely affected by a lack of visible liquidity on Canadian marketplaces. It was noted that the amendments to NI 21-101 in January 2004 to eliminate the electronic connection between marketplaces significantly complicated the ability of market participants to ensure that they can obtain best execution in circumstances when there are multiple marketplaces trading the same security.

(b) Unlisted equity securities – The comments generally indicated that the lack of transparency is the biggest factor affecting the quality of execution in this market. One commenter noted that is no reason to assume that the quality of execution in OTC markets is any poorer than listed markets; however, the difficulties in measuring best execution due to the lack of transparency is of concern.

(c) Derivatives – Two commenters indicated that transparency is an issue affecting quality of execution. One commenter noted that derivatives present liquidity issues because there is a limited number of dealers, typically the bank-owned investment dealers, who will trade these instruments. One commenter stated that while there are no significant concerns that hinder the quality of execution at the moment, regulation surrounding issues such as swap agreements, hybrid instruments and single stock futures must be rigorously analyzed to assure that market participants are receiving best execution.

(d) Debt – Many commenters stated that the level of debt market transparency makes the measurement of best execution difficult.

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

The majority of commenters believed that, wherever possible, Canadian dealers using foreign brokers should use the same standards of measurement as they do when executing trades in Canada.

Some commenters suggested possible ways for Canadian dealers to monitor foreign brokers: comparing realized execution prices against various benchmarks such as arrival price, VWAP and post trade price; using per-share rates from electronic trading systems as the encumbered-free commission rate; periodically evaluating the execution performance of the foreign brokers based on various factors including obtaining the best qualitative transactions for clients and other factors such as confidentiality provided by the broker, the promptness of execution and clearing and settlement capabilities. Pre-and post-trade analysis may be necessary.

A few commenters thought that this would be difficult as a result of lack of available market and execution data. One commenter noted that, as best execution is a balancing of competing priorities, it is impossible to measure but the registered representative handling the order should evaluate execution using the same elements described in the paper in addition to client's instructions, liquidity, size of order and ability to settle.

One commenter noted that an extensive knowledge of the foreign market and knowing and trusting the broker executing the order is imperative.

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

Many commenters believed that, if current rules are complied with, internalization should not be an impediment to best execution. Many of these commenters noted that any internalization of trades must still comply with the dealer's obligation of best execution.

Other commenters stated that internalization of orders may be an impediment to best execution. One commenter noted that the internalization of orders inhibits the flow of information which is vital to achieving best execution. In addition, the internalization of order flow contributes to a lack of liquidity in marketplaces which also represents an impediment to achieving best execution.

One commenter noted that order execution for a mutual fund should go to the lowest responsible provider whether internal or not. One commenter noted that it supported internal crossing by investment managers but believed that widespread internalization by dealers has the potential to impeded best execution if dealers hold up orders while looking for offsetting internal order flow. One commenter noted that internalization provides the potential of some benefits such as enhanced liquidity, faster execution and lower transaction costs and it may preserve anonymity; some of the drawbacks are potential impediments to liquidity and the price discovery process since orders are not exposed to the market. It was noted that, if properly disclosed, internalization should be preserved.

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 of Securities Dealers, Inc. (NASD) requirements dealing with fair prices)?

<u>Multiple quotes</u>
Most commenters thought that, given the size of Canadian OTC markets, a requirement to obtain multiple quotes is not needed. Some thought that such a requirement may have a negative impact on the price of the securities, as a request for a quote for a security may send a signal and, as a result, may cause the security price to move against the intended trade. Some

thought that obtaining multiple quotes would not be possible because multiple quotes may not be available in the current Canadian market. A few thought that a multiple quote requirement would even hamper best execution, since the process for obtaining them would be time consuming, especially for dealers for whom the immediacy of execution is the primary goal. Some thought that requiring dealers to get multiple quotes is not necessary, since the dealers are already expected to perform due diligence in seeking best execution for client under the existing rules. Only one commenter thought that dealers should be required to obtain multiple quotes, to address conflicts of interest such as those related to soft dollar arrangements. Another recommended that, while dealers should not be required to obtain multiple quotes, they should document their decision to seek out single or multiple quotes as part of the process to measure best execution.

Mark-ups

Most commenters did not support a mark-up rule for the following reasons: (1) the customized nature of many OTC products renders the requirement for a mark-up rule unnecessary; (2) market forces and competition keep spreads in line; (2) a principles-based approach should be adopted, and no additional rules are required; (3) a mark-up rule would be difficult to incorporate and should not be adopted on the institutional side, as the mark-up, as a percentage, depends on many factors (e.g. the particulars of a trade, the size of the principal amounts traded, risk assumed, the amount of time a security was in inventory, etc.); (4) cost related mark-up rules should only be considered if the cost of capital for carrying inventory is taken into account, and, for this reason, the internal audit function within a firm is in a better position to monitor the client interest than a market regulator; (5) the current rules are sufficient.

The commenters supporting mark-up related rules noted that: (1) such a rule would be necessary because unsophisticated investors are taken advantage of, and a rule may be needed on the retail side; (2) an approach similar to the NASD's Rule 2440 may be appropriate; (3) CSA guidance on what constitutes an "excessive" for mark-ups and what criteria should be used is needed.

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?

Some commenters noted that it is difficult or even impossible to measure and track execution quality without readily available market data. One suggested that investors must rely on competitive bidding processes to increase the likelihood that they will achieve best execution and another that they would have to rely on internal dealer data, which is insufficient to make an accurate assessment.

Other commenters noted that, while the price of security at the time of the order and immediately after execution may not be ascertained without the pre- or post-trade transparency, this is only a single parameter and, while useful in practicing best execution, pre and post-trade analytics should not be used as a benchmark for measuring it. It was noted, again, that the best net result should be the result of the entire process. Another commenter noted that pre-trade and post-trade transparency aid in achieving best execution and are necessary elements in tracking and evaluating execution quality. Without such information, execution opportunities cannot be evaluated either prior to or subsequent to execution.

Finally, other commenters noted that there are alternatives for a general evaluation of best execution, for example: (1) use of a service to which a number of large dealers subscribe that

takes trade information and compares it, letting dealers' clients know whether their prices are competitive with others; (2) obtaining previous trading night's spreads, third party automated trading platforms and any available information from index providers as proxies for pricing for individual debt issues and guidance on the direction the market may be trading; and (3) access to real time post-trade transparency in all markets.

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

Certain commenters thought soft dollar arrangements are not consistent with best execution and other general obligations to clients, and thought that they should be eliminated in the long term. However, two of these commenters thought that, in the interim, soft dollar policies should be tightened.

The following suggestions were made: (1) tracking and managing proprietary and third party independent soft dollar arrangements for disclosure purposes; (2) requiring advisers to disclose to clients regarding soft dollar arrangements; (3) requiring advisers to disclose the amount of soft dollar business conducted during the period and of the resources acquired with soft dollars (4) requiring disclosure of conflicts of interest, such as broker-consultant relationships (5) better education of clients; (6) client acknowledgement of soft dollar arrangements in form of a waiver.

Some commenters suggested that advisers be required to implement policies and procedures that would: (1) define expenses that may be paid through soft dollar commissions; (2) describe the monitoring, reporting and control processes to address potential conflict of interest issues; (3) describe the approval processes for new soft dollar arrangements; (4) place limits on the soft dollars in relation to the overall trading commissions; (5) require that soft dollars be spent in the best interest of investors or unitholders; (6) review of soft dollar policies.

Some noted that advisers that participate in soft dollar arrangements should have adequate controls and compliance structure in order to: (1) check that soft dollars are used only to obtain appropriate products and services; (2) meet all regulatory requirements; (3) make all proper disclosure to clients; and (4) review, approve, limit soft dollar expenditures and create a standard disclosure document for clients.

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

Benefits

One commenter noted that third-party soft dollar arrangements are beneficial to clients, especially smaller investment advisers, as they tend to have smaller research departments and benefit from research from a wide array of independent sources, allowing them to compete with their larger competitors.

Some reiterated the comment made in the concept paper that soft dollars allow independent research providers to compete with large full-service brokerage firms, which is beneficial in an environment where regulators are trying to encourage more independent research.

Concerns

One commenter noted that soft dollar arrangements give rise to issues such as the "fairness" between clients or funds managed by an investment adviser, for example when commissions from trades in some funds generate soft dollars, but these soft dollars are used for the benefit

for all funds, including those that did not generate them. Another noted that soft dollars may inadvertently result in unnecessary portfolio turnover, when buy side investors are required to meet incomplete soft dollar obligations late in the year and do not have the "natural" flow with which to do so.

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?

Most commenters supported the approach taken by the FSA and the NASD Mutual Fund Task Force, where soft dollars are limited to execution and research, and high-level guidance on the characteristics of 'research' services and detailed guidance on services that would not be permitted is expected. A few listed the services that should be excluded from the definition of "investment decision-making services": (1) computer hardware, software, databases and other electronic communications facilities used in connection with trading or investment decision-making; (2) publications, including books, periodicals, journals and electronic publications available to the general public on a commercial basis such as newspaper subscriptions, Bloomberg terminals, computer equipment, office supplies, seminar fees and travel or entertainment (in general, any expenses incurred by an adviser within the regular operation and administration of their organization separate from the investment process); (3) third-party research services; and (4) consultant fees.

One commenter thought that order-execution services should include trade execution, execution software packages and charges associated with accessing capital to assist execution. Another thought that the advisers should be left to decide on their own, consistent with their fiduciary duty to clients, which services provide assistance in their investment decision making process and noted that some products, such as data feeds, quotes, news, analysis, analytic and customizable functions, are research related even though they are not the traditional written research reports. This commenter noted that what constitutes lawful and appropriate assistance depends on the facts and circumstances and is not susceptible to hard and fast rules or a laundry list of specified items.

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?

Almost all commenters agreed that additional and better disclosure is needed. The following disclosure was suggested: (1) commissions used to obtain both proprietary and independent research; (2) soft-dollar benefits received by portfolio managers, in aggregate and/or pro-rated to the account of each client where technology exists to do so; (3) disclosure of the brokerage commissions as a percentage of average fund assets for the immediate past year and the previous 4 years, with the Summary of Portfolio Transactions made available upon request to investors; (4) disclosure similar to FSA Schedule F of Form ADV Part II for a description of the relationship between an advising firm and any third party that may provide services to the advisor; (5) for prospectus funds, the 'brokerage arrangements' disclosure required by section 10.4 of NI 81-101F2 should be expanded to include the various types of trading costs incurred by the fund including: commissions, markups and markdowns, market impact costs, opportunity costs, the manner in which the fund selects brokers to effect securities transactions, and the manner in which the fund will evaluate the overall reasonableness of the brokerage commissions paid (including the factors used by the fund in making these determination); (6) for

non-prospectus funds, similar disclosure but in financial statements or offering documents; (7) disclosure of services acquired with commissions and the value derived from their use; and (8) disclosure of policies of portfolio managers aimed at treating all clients equitably in the purchase of and benefits from the use of order execution and investment decision-making services.

The following concerns were identified in this area: (1) without an accurate accounting of the breakdown of execution and research costs included in the commission structure any disclosure of the cost of proprietary research will be based on estimates and will vary between advisers; (2) for this reason, additional disclosure could result in confusion among investors who do not have the appropriate knowledge to appreciate the information provided, and may not be accurate or meaningful.

Some commenters thought that the disclosure should be the same for third party soft dollar payments and bundled commissions, for the following reasons: (1) to attract the same regulatory approach; (2) disclosure of only third party soft dollar arrangements would be misleading because it does not accurately represent the full cost of research that may be paid by an adviser, which would include proprietary research paid through bundled commissions; (3) different disclosure requirements could lead to an unlevel playing field and unfairly discriminate against third party research providers. Only one commenter thought the disclosure should be different.

Question 15: What, if any, are the practical impediments to an adviser: (a) splitting into their component parts commission payments that compensate for both order execution and "investment decision-making services" as a result of either third party soft dollar arrangements or bundled commissions; or (b) making a reasonable allocation of the cost of "investment decision-making services" to the beneficiaries of those services (for example, allocating across mutual funds)?

(a) Some commenters believed that separation of commission payments into their components as a result of third party arrangements is possible. One way to do it is through the invoicing provided by the service providers. Some also believed that there should be no impediments to unbundling. However, the majority thought there were impediments to splitting commissions into their components, for example: (1) unbundling would be cumbersome, arbitrary and costly; (2) it would require implementation of a process, an audit trail to ensure compliance, an appropriate method of reporting; (3) there may be inconsistencies between allocations between trades, since a split would depend on a number of factors (e.g. the nature of the security, the particulars of the trade, whether the commission includes proprietary research services), and these factors may have different weights between trades; an adviser would need information from dealers, and it could be difficult to obtain consistent information from different dealers, as they quote the same commission rate whether it is quoted on a bundled or full-service basis; and (4) the very nature of bundling does not allow for a split.

(b) A few commenters thought that an allocation of "investment decision-making services" to the beneficiaries of those services should not be problematic. One thought that any commission splitting rules would need to ensure a fair and reasonable allocation, possibly with auditor testing. Another noted that this could be done but only if dealers disaggregate the commission costs and provide information to the 'buy side' firms, such as advisers. One thought such an allocation is not necessary because research products used by investment managers benefit all accounts and/or funds managed.

However, the majority thought that there were significant impediments to such allocation, such as: (1) in a large fund complex, not all funds necessarily generate commission dollars that contribute to soft dollars, but all funds under common management may benefit from them and, for this reason, an allocation may result in an arbitrary calculation and may not add real value to fund investors; (2) such an allocation would require a large amount of judgement and that information regarding commissions is obtained from the dealers used by advisers, which may be difficult; (3) the scale of operations and technology used to administer client accounts; and (4) the administrative cost associated with performing this task would be high, the process would be subjective and not necessarily consistent, and it would require administration by the portfolio manager, which would take time away from the investment process.

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?

The majority of commenters thought that the entire commission should not be accounted for as an operating expense. The reasons given were: (1) the inclusion of commissions (outside of soft dollar commissions) as operating expenses may result in a shift of trading from an "agency" basis to a "principal" basis, which has the potential for higher transaction costs, or would result in an industry-wide movement towards net trading, effectively reducing explicit commissions to zero by embedding commission costs into trade execution prices, which would not provide transparency to the investment community; (2) such an accounting treatment may lead to inconsistencies and a possible competitive disadvantage of Canadian managers in relation to managers in other jurisdictions, and Canadian managers may be forced to increase management fees to compensate for the increase in bottom line expenses increase; (3) the gross performance data for a fund would be impacted by a change in accounting treatment; and (4) it would lead to different accounting for different asset types, for example, commissions on equity trades would be included as an operating expense, whereas imbedded commissions on debt trades would be a capital item. Most commenters agreed that a split between commissions related to order execution and investment-decision making services cannot be done accurately, and for this reason it would be difficult, or it would not make sense to separate them on the financial statements.

Two commenters thought that both order execution and investment decision-making services should be accounted for as an operating expense. Finally, some thought that additional disclosure may be better, for example, by disclosing the amount of portfolio-related transaction costs. One commenter thought that only the third-party soft dollar cost can be measured accurately and should be included in the operating expense in the financial statements.

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"?

Most commenters thought it would not be appropriate for the MER to be based on amounts that differ from the expenses recognized in the audited financial statements. The reasons were: (1) under this approach, the resulting MER would be volatile and dependent on market

conditions/trading strategies; (2) use of differing amounts may lead to investor confusion and could be harmful to investors, as it would encourage fund managers to exert pressure on fund managers to keep trading low in order to keep the MER low, or it may encourage portfolio managers to execute net trades; (3) if the MER were based on different amounts from what is recognized in the audited financial statements the commission costs related to different asset types (i.e. equity and debt) would be treated differently; and (4) including all, or part of the commissions into the MER could have the effect of obscuring the true operating expenses of the fund. One commenter thought that it would be appropriate for the MER to reflect the third party soft dollar payments made. A few thought that the requirements of NI 81-101 to include the Trading Expense Ratio, in which the total commissions paid are expressed as a percentage of the average fund assets, in the Management Report on Fund Performance may help provide additional information.

Question 18: Should directed brokerage or commission recapture arrangements be limited or prohibited?

Four commenters noted that commission recapture arrangements can provide significant value to a fund (as they can be used to pay a portion of a fund's expenses) and should not be prohibited. One commenter noted that these arrangements should be allowed to continue as they do not appear to be problematic in the Canadian markets at this time.

Two commenters thought that these arrangements should be prohibited. One commenter believed that these arrangements should be prohibited as they involve an inherent conflict of interest. Another commenter believed that directed brokerage should be prohibited as it can lead to purchasing unduly expensive or unsuitable funds and compromises the impartiality of advice.

Many commenters raised concerns with these arrangements. One commenter noted that it could not think of a way to ensure best execution using either directed or recaptured commissions. Another commenter noted that it did not generally support the notion of directed brokerage or commission recapture; however, it did not support the elimination of commission recapture without a clearer understanding of the industry fall-out from such a decision. One commenter noted that, though neither directed brokerage or commission recapture arrangements are considered contentious issues at the moment in Canada, it may be in the best interest to implement regulatory reforms that would limit both directed brokerage and commission recapture with a promise to prohibit them at a later date. Another commenter noted that if client-directed brokerage and commission recapture continue to be permitted, the CSA should grant the adviser an exemption from its fiduciary duty to obtain best execution for these trades.

Some commenters noted that there is a strong duty to demonstrate that quality of execution is not being compromised. One commenter noted that where a client requests a directed brokerage arrangement, the adviser's ability to achieve best execution is compromised and the adviser has a responsibility to educate the client about the consequences of such a decision. Another commenter emphasized that if directed brokerage or commission recapture arrangements are to be tolerated, there should be explicit consent from the client.

One commenter believed that directed brokerage (as defined in NI 81-105) is already sufficiently regulated; however, there should be a level playing field among the various types of investment funds offered.

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

The majority of commenters agreed that full disclosure of these arrangements is appropriate. One commenter noted that, on the basis that directed brokerage (as defined in NI 81-105) is not permitted, there is no need for disclosure of such arrangements, but agreed in principle that there should be disclosure for commission recapture arrangements. One commenter suggested that, if the CSA leave directed brokerage and commission recapture arrangements in place, clients should have the ability to ask for additional information, which the adviser should then be required to provide.

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

Several commenters believed that the developments in other jurisdictions should be closely observed. One commenter noted that Canada should exercise caution in considering the pursuit of initiatives from other jurisdictions until those jurisdictions actually implement the initiatives. One commenter supported the concept of establishing uniform guidelines around the issue of soft dollars.

Three commenters suggested that SEC rules 11Ac1-5 and 11Ac1-6 (Disclosure of order execution and routing practices) may be advantageous in Canada. One commenter did not believe that the production of periodic "best execution" reports by marktplaces or dealers would be productive. It was stated that these reports provide a mass of data but little in the way of information that would be meaningful for most investors, particularly retail investors.

II. Other comments

Role of plan sponsor/ administrator - Two commenters noted that there should be additional direction on the use of commission by the plan sponsor/administrator and their role in best execution should not be overlooked.

Term "soft dollars"- One commenter recommended that the term "soft dollars" not be used and that the rules and policies deal with the legitimate and acceptable use of commission dollars to acquire goods and services that benefit the client. The FSA has adopted this approach. The term "soft dollars" has always been a "lightning rod" in attracting confusion and criticism and in creating the impression that one is paying for something and not getting full value.

Trade-throughs - Several commenters referred to the current trade-through issue. One commenter noted that no trade-throughs should be allowed on single stock orders and all market participants should be required to create an infrastructure to ensure that no trade-throughs take place (and prefer that rules be enacted immediately to ensure that no trade-throughs take place during the lengthy CSA consultation period regarding trade-throughs). Another commenter stated that there is no reason why a party participating on an ATS trade should not have to satisfy demand for securities as disclosed on the bid or offering side of the market at prices better than the proposed trade exercise price. One commenter noted that market regulators should continue efforts at securing best execution for investors by strengthening regulation to prevent trade-throughs on Canadian equity marketplaces.

On the other hand, one commenter noted that a prohibition from trading through limit orders can be an obstacle for investment managers rather than helping facilitate best execution. Another

commenter stated that the “trade-through” rule can have negative consequences that include restricting free market competition and over-regulation that stifles innovation and believed that there is no need to make changes to the current “trade-through” obligations to impose burdens on “access persons” that they do not currently have. This commenter believed that economic self-interest and the rational behaviour of participants is enough to ensure that actual trade-throughs will be the exception.

Harmonize response - If following the review of the responses to the concept paper the CSA determines that changes to the current regulatory framework are necessary, urge the CSA to ensure that any regulatory initiative should be national in scope and application.

List of commenters

1. Aurion Capital Management Inc.
2. Barclays Global Investors
3. BMO Nesbitt Burns
4. BNY Securities Group
5. Canadian Bankers Association
6. Canadian Security Traders Association, Inc.
7. CIBC World Markets
8. Commission Direct
9. CPP Investment Board
10. Financial Executives International Canada
11. Howson Tattersall Investment Counsel
12. Investment Dealers Association of Canada
13. Investment Funds Institute of Canada
14. Kenmar
15. Lynch, Jones & Ryan
16. Mackenzie Financial Corporation and Investors Group Inc.
17. Markets Securities Inc.
18. Market Regulation Services Inc.
19. Perimeter Financial Corp.
20. RBC Capital Markets
21. RBC Asset Management
22. RBC Global Services
23. Russell Investment Group
24. Shorcan
25. TD Asset Management
26. TD Newcrest
27. National Society of Compliance Professionals
28. TSX Group