The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

April 8, 2008

Institute's Comment Letter - Canadian Securities Administrators' Revised Proposal on Soft Dollars (pdf)

April 8, 2008 Canadian Securities Administrators c/o John Stevenson, Secretary Ontario Securities Commission 20 Queen Street West Suite 1903, Box 55 Toronto, Ontario, M5H 3S8 CANADA RE: Notice of Proposed NI 23-102 Use of Client Brokerage Commissions as Payment for Order Execution Services or Research Services and Companion Policy 23-102CP Dear Mr. Stevenson: The Investment Company Institute (ICI)1 appreciates the opportunity to comment on the revised proposal of the Canadian Securities Administrators (CSA) on the use of client brokerage commissions as payment for order execution services or research services (proposed National Instrument 23-102). The ICI has a keen interest in this proposal because many of our members operate in the Canadian market. Many of our members also are registered in Canada or advise Canadian clients through subadvisory agreements. We welcome some of the changes that the CSA has made to the proposal in response to comments on the original proposal, including those of the ICI. We, however, have significant concerns with the proposal to require separate disclosure of order execution costs and the costs of other execution and research services ("unbundling").2 For the reasons described below, we believe that requiring investment managers to provide unbundled disclosure would result in disclosure of costs that would be meaningless to clients. Moreover, this step would move the CSA in a direction completely 1 The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $12.34 trillion and serve almost 90 million shareholders. 2 We submitted a comment letter to the CSA on the original proposal in October 2006. See Letter to John Stevenson from Robert G. Grohowski, Senior Counsel, Investment Company Institute (dated Oct. 19, 2006) available at http://www.ici.org/statements/cmltr/06_canada_soft_dollar_com.html#TopOfPage. Letter to Mr. John Stevenson April 8, 2008 Page 2 of 7 different from that taken by the U.S. Securities and Exchange Commission (SEC) and other jurisdictions.3 Such a step would require U.S. firms operating in Canada to create an entirely new and separate system for valuing components of client brokerage commissions, which, as we discuss below, would be problematic. In this letter, we also provide comments on several specific aspects of the revised proposal, including: (1) the criteria for the permissible payment for raw data with brokerage commissions; (2) the exclusion of telephone and communication lines from the

permissible use of brokerage commissions; (3) the temporal standard of when order execution services begin; (4) the obligation of advisers to obtain brokerage commission information from subadvisers not subject to CSA's requirements; (5) the allocation of benefits to clients; and (6) the transition period for a final rule. We discuss all of these comments in more detail below. Separate "Estimates" by Investment Managers of Order Execution Costs and Other Execution and Research Costs Would Be Meaningless to Clients The CSA proposal would require investment managers to disclose separately the portion of total client brokerage commissions paid during the period that represents the "amount paid or accumulated to pay for goods and services other than order execution." This quantitative disclosure would be in addition to the required disclosure of the total client brokerage commissions paid during the relevant period. We strongly support the CSA's goal of providing greater transparency to the use of brokerage commissions by investment managers so that clients are better equipped to monitor their advisers for potential conflicts of interest. We disagree, however, that requiring "estimates" would provide clients with an effective tool for monitoring advisers. The information that the CSA is proposing to require would only lead to client and market confusion and hinder, rather than assist, clients in ensuring that their brokerage commissions are being used for their benefit. We have several significant concerns with this aspect of the proposal, which, in effect, requires unbundling of services provided by brokers. First, unless the CSA imposes an obligation on brokers to provide investment managers with information on the monetary value of the execution and research components of the brokerage commissions paid, the estimates made by individual investment managers would be entirely subjective. For this reason, clients could not use the disclosure to make comparisons in any meaningful way. For example, investment managers using the same broker may allocate differing values for execution as well as for the other services received from the same broker. These differing estimates would not provide clients with any basis for comparison. Therefore, this disclosure would not provide objective 3 See infra note 5. Letter to Mr. John Stevenson April 8, 2008 Page 3 of 7 information that clients could use to monitor the investment managers for potential conflicts of interest. Moreover, we do not believe that there is an "execution-only" commission rate that could be used to value execution services and permit investment managers to determine "indirectly" the value of all other services received from the brokerage commissions. Given the variety of factors impacting a particular trade, it is our view that one commission rate could not be applied to all brokers in all trading situations or even for a particular type of security. Second, although the CSA noted that the proposed new standard to make a "reasonable estimate" of the amounts paid for goods and services other than order execution is consistent with the disclosure presently required to be made by investment funds, this proposal is a significant departure from the current standard. Under the standard imposed by NI 81-106, investment funds must disclose the amounts to the "extent ascertainable." We understand this standard to require investment funds to disclose the amounts if they are able to obtain information about costs that can be allocated to order execution and research services other than order execution. In other words, the current standard does not require investment funds to "guess" the amounts when they are not otherwise able to obtain this information. Third, we are concerned that the CSA's new unbundling requirement moves the Canadian brokerage commission regime along a completely different path from that being pursued by the SEC.4 This divergence in regulatory approaches will require firms providing services to both Canadian and U.S. clients to create a new system to "estimate" values of the goods and services purchased with brokerage commissions.5 We recognize and well appreciate that the CSA must make policy decisions based on what is appropriate for the Canadian market and to protect Canadian investors (which may at times dictate that the CSA take a course of action that differs from the SEC and other jurisdictions). In this situation, however, given the other

concerns we have raised, we do not believe that CSA's divergence 4 The SEC recently announced that it is proposing to revise Part II of the registration form for investment advisers in the U.S. (Part II of Form ADV). The proposed Part II of Form ADV would require expanded soft dollar disclosure, including a requirement for advisers to specify the types of products and services they received in exchange for soft dollars similar to the CSA's proposal. It does not appear, however, that the SEC will propose any new quantitative disclosures from advisers. See Amendments to Form ADV, Release No. IA-2711 (Mar. 3, 2008) available at http://www.sec.gov/rules/proposed/2008/ia- 2711.pdf. 5 In addition, we note that the majority of IOSCO's SC5 (Standing Committee on Investment Management) jurisdictions do not appear to require the quantitative disclosure contemplated under this proposal. See Final Report of the Technical Committee of IOSCO on Soft Commission Arrangements for Collective Investment Schemes (Nov. 2007) ("IOSCO Soft Commission Report") available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD255.pdf. Letter to Mr. John Stevenson April 8, 2008 Page 4 of 7 from the U.S. approach would yield any significant benefit that would outweigh the burden to firms operating in both markets. Finally, the CSA requested comment on what difficulties would be encountered if the commissions were required to be split between research services and order execution services. Again, we believe that estimates of the value of research and order execution services made by investment managers individually would be subjective without an explicit requirement on brokers to provide that information. Therefore, a detailed breakdown between research services and order execution services would necessitate guesswork and result in meaningless disclosure to clients. The different temporal standards for order execution services of the CSA and the SEC also would make this disclosure complicated for firms operating in both markets without any corresponding benefit.6 For the above reasons, we hope that the CSA will reconsider the proposed quantitative disclosure requirement and not mandate separate disclosure of the value of research and order execution services. We believe the quantitative requirement to disclose total brokerage commissions paid by the client during the reporting period and an aggregated total of client brokerage commissions paid during the period in addition to the narrative disclosure would give clients more accurate information. Criteria for Raw Data Is Unnecessary and Unfair Under the proposal, payment for raw data may be made with brokerage commissions if the raw data provides value to the investment decision-making process and has been or will be "analyzed or manipulated by the adviser to arrive at meaningful conclusions." We question the need for this second criterion. Permitting raw data that adds value to an investment manager's investment decision-making process would be sufficient to ensure the data benefits the client. Requiring "analysis or manipulation" to arrive at a "meaningful conclusion" would only contribute to the confusion as to what kind of analysis or manipulation an adviser needs to undertake for the raw data to be permissible. The basic criterion of adding value to the investment decision- making process would ensure that clients benefit from the service purchased with their commissions. Moreover, this additional criterion would be burdensome to investment managers that operate in both the U.S. and Canadian markets because the SEC specifically permits the use of raw data that provides appropriate assistance to an investment manager in the performance of its investment decision-making responsibilities. Because an investment manager may not be able (or find it extremely 6 Moreover, we question whether the benefit is even necessary given, as noted in IOSCO's report on soft dollars, most of the SC5 jurisdictions, including Ontario and Quebec, reported no enforcement actions in this area (with two enforcement actions in the U.S.) and many jurisdictions reported no complaints. See IOSCO Soft Commission Report (Appendix 1, Question 4). Letter to Mr. John Stevenson April 8, 2008 Page 5 of 7 difficult) to allocate this benefit to specific clients (U.S. or Canadian), an adviser may not be able to pay for raw data with brokerage commissions for any of its clients. We respectfully request that the CSA

eliminate this additional criterion, which is only imposed for raw data. Telephone and Data Communication Lines Should Be Treated as Mixed-Use Goods and Services Under the proposal, the CSA would treat telephone and data communication lines, including dedicated communication lines, as outside of the permissible use of brokerage commissions. The CSA is of the belief that these services are similar to overhead costs. We believe that communication services that assist in effecting securities transactions should come within the definition of order execution services. Overhead is generally goods and services that investment managers must incur to conduct their business and do not necessarily provide appropriate assistance to the adviser in making investment decisions or effecting securities transactions. We recognize that telephone and data communication lines can be used for purposes other than for order execution. If these lines are used for multiple purposes, the investment manager, as with other mixed-use items, should ensure that brokerage commissions are used to pay for only those portions of the services that are used for execution purposes. Moreover, investment managers participating in both the Canadian and U.S. markets would be required to treat telephone and data communication lines differently because the SEC permits communications services related to the execution, clearing and settlement of securities transactions and other functions incidental to effecting transactions to be paid with brokerage commissions. As recognized by the CSA, investment managers will find it difficult to allocate specific services that were used for individual clients. This difficulty in itemizing services for individual clients could mean that investment managers participating in both markets, in effect, would not be able to pay for any portion of telephone and data communication lines with brokerage commissions in order to comply with the CSA requirements. This result would be particularly onerous for firms that have only a small percentage of Canadian clients. Differing Temporal Standard for Order Execution Services Can Be Burdensome to Firms if the CSA Requires Separate Disclosure of Research and Order Execution Services Under the CSA proposal, order execution services begin after the adviser has made its investment decision while the SEC considers brokerage services to begin when an order is communicated to a broker-dealer. To the extent that the standards make different determinations of the point in time when research services end and brokerage services begin, the eligibility of particular goods or services should not be affected. If, however, the CSA determines to require separate quantitative disclosure of research services and order execution services, then the different temporal Letter to Mr. John Stevenson April 8, 2008 Page 6 of 7 standards will raise significant issues for investment managers that operate both in the U.S. and Canada. Obligation of Investment Managers to Obtain Information from Subadvisers To comply with the requirements of the proposal, it appears the CSA would require CSA- regulated investment managers to obtain “unbundled” information from subadvisers that are not otherwise subject to this regulation. As is the case for U.S. subadvisers, these subadvisers may be operating under a regulatory regime for the use of brokerage commissions that does not require unbundling. The unfortunate result of this obligation is that the CSA is either indirectly imposing these requirements on foreign subadvisers or discouraging foreign subadvisers (including U.S. subadvisers) from servicing Canadian clients. For those foreign subadvisers who are not subject to unbundled disclosure, such as U.S. subadvisers, the CSA proposal would substantially increase their costs because these subadvisers would need to make significant changes to their systems infrastructure to unbundle the costs of execution and other services and products. We believe that the CSA’s calculation of $2,800 one-time cost per firm to comply with the new requirements greatly underestimates the burden that would be imposed on these firms. Furthermore, we expect that there would be additional ongoing costs associated with the new requirements. Consequently, the substantial additional cost of instituting a system for foreign firms would greatly increase the cost of obtaining global diversification for Canadian investors. We believe this result would harm,

rather than benefit, Canadian clients. Determination of Benefits to Clients Should Be on An Aggregate Basis According to the CSA, subsection 4.1(3) was added to the proposal to clarify that advisers were not required to ensure that a direct connection exists between each specific good or service received and particular clients. The language of the subsection, however, remains ambiguous regarding whether advisers would be required to make a determination that a good or service received was fair and reasonable on a client-by-client basis. We do not believe the CSA intended investment managers to make an individualized determination of benefits to clients. In the most recent CSA proposal, CSA acknowledged that goods and services received benefit a number of clients and may not always be specifically matched to each client account generating the commissions. Moreover, the CSA amended the proposal to clarify that an investment adviser had the option of making the determination that the amount of commissions paid is reasonable in relation to the value of goods and services received in terms of the adviser's overall responsibilities for client accounts. We, therefore, seek clarification that investment managers would have the option to determine whether the benefits were fair and reasonable on an aggregate basis. Letter to Mr. John Stevenson April 8, 2008 Page 7 of 7 Transition Period Should Be at Least One Year If Quantitative Disclosure Requirements Are Not Revised If the CSA, despite our comments, decides to adopt the quantitative disclosure requirements as proposed, we believe a six-month transition period would not be sufficient for investment managers to be able to comply with these requirements. Cost allocation methodologies would have to be created and systems would have to be developed to be able to provide estimates for the quantitative disclosure. We request that CSA provide a minimum of one-year for a transition period. * * * * We appreciate the opportunity to express our views on this important topic. If you have any questions about our comments or need additional information, please contact me at solson@ici.org or at (202) 326-5813. Sincerely, /s/ Susan M. Olson Susan M. Olson Senior Counsel, International Affairs cc: British Columbia Securities Commission Alberta Securities Commission Saskatchewan Securities Commission Manitoba Securities Commission Ontario Securities Commission New Brunswick Securities Commission Securities Office, Price 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 M. Anne-Marie Beaudoin, Directrice du Secrétariat, Autorité des Marchés Financiers (Quebec)
