Kenmar
The Fund OBSERVER

April 5, 2005

British Columbia Securities Commission
Alberta Securities Commission
Manitoba Securities Commission
Ontario Securities Commission

c/o John Stevenson, Secretary
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Dear Mr. Stevenson and Ms. Beaudoin:

Subject : CONCEPT PAPER 23-402 *BEST EXECUTION AND SOFT DOLLAR ARRANGEMENTS*

Kenmar welcomes the opportunity to comment on these proposals. In our view, the *primary* purpose of securities regulations and regulators is to protect investors. It is in this context that we examine 23-402 with a focus on actively- managed mutual funds sold to small retail investors. The same principles however apply to Segregated funds, LSIF's index funds, ETF's and even to hedge funds. Some 10 million Canadians invest in mutual funds as the backbone of their retirement nest eggs. Canadian mutual fund assets are approximately half a trillion dollars spread among about 5000 funds of various types and classes. In a very real sense, mutual funds and other investment funds are the dominant traders on the TSX and VSX.

By way of introduction, Kenmar is an Ontario based organization focused on mutual fund investor education via on-line papers hosted at www.canadianfundwatch.com. Kenmar also publishes ***the Fund Observer*** on a monthly basis discussing investor protection issues primarily for mutual fund investors. A subsidiary, Portfolio Analytics, assists investors and/or their counsel in filing investor restitution claims.

A. Preamble -An investors perspective

Best execution is closely linked to soft dollars. Soft dollar trading has long been on the list of investor complaints and concerns. Soft dollars are among the "least visible" and "least understood" opaque expenses for investors. As long as the trading commission is not too far from industry norms, it's probably okay under *best execution* criteria. Whenever huge conflicts-of interest meet huge sums of money, big problems will arise. The soft-dollar system is regarded as so inappropriate, retail investors have a hard time believing that anything like it could be allowed to exist in contemporary mature financial markets.

Good trade execution is especially important for mutual funds that due to their nature deal with large numbers of shares. There is a tradeoff between favouring long-term investors (e.g. most mutual funds) and short-term traders by requiring markets to privilege price over speed of execution. Sometimes, the trades are through related parties since some fund companies are part of organizations that also own brokerage firms. For tax reasons, trading commission costs do not form part of the MER calculation but they are a cost, often significant, that the fund (the retail investor) incurs. Conversely, auditor and custodian fees, usually a much smaller cost, however are part of the MER calculation and are isolable costs on financial statements. Commissions paid are generally reported in the Annual financial statements of each fund, usually in the NOTES section giving them no context. Improvements are needed-soft dollars gives advisers an unhealthy incentive to unduly pay for services with soft dollars, thereby enabling them to artificially lower their management fees and the fund's published and publicized MER. This can adversely distort a retail investor's decision process.

Generally, "soft dollars" are considered to be brokerage commissions which are used to pay for products and/or services not directly related to order (trade) execution [i.e. they are an integral part of a manager's cost of doing business]. "Soft dollars" is thus a term used to describe a situation where a mutual fund places trade execution orders in exchange for other services such as research reports [but it can be (mis) used to mask preferred broker promotion of the fund -aka directed brokerage]. We exclude transfers of securities between funds and inventory from our discussion. Generally, the understanding is not well documented and even if properly documented is invisible to investors. Soft dollar supporters point out that if soft dollar trading is banned, fund MER's will rise even above their already lofty levels. Some small fund firms state that without soft dollars trading they could not economically access investment research and maintain current MER levels. Still others state that the cost is indirectly reflected in publicly disclosed return performance data so why should investors care about the details.

Opponents point out that *best execution* is a fuzzy term related to some combination of low costs, customer service, speed of execution, best price, volume discounts etc and hence not readily measurable and therefore unenforceable. Soft dollars can lead to higher fund costs and excessive portfolio turnover. It is possible that some funds even subsidize others through soft dollar transactions. Beyond the numbers, soft dollars trading is not a practice consistent with an ethical fund company culture and can unnecessarily lead to serious proper business conduct issues and conflicts- of- interest. The one cost-benefit analysis we've seen had controversial assumptions, a marginal benefit and ignored the added governance risk to fund unitholders. It is our belief that the prohibition of soft dollar transactions will provide a greater good to a large stakeholder base and hence is in the public interest.

Among pension funds, it has generally been agreed that soft dollars trading is not a best practice and it may have hurt fund performance. Indeed, it may have contributed to a climate of investor abuse.

"That (soft dollars) is a no-no here. And I would say that should be an absolute no-no for anybody, because that's so rife with conflict- of- interest it shouldn't even be touched with a 10-foot pole."

- Bob Bertram, executive vice-president of investments with the $76-billion Ontario Teachers Pension Plan fund

Source: Sinclair Stewart, "Outcry over 'soft dollars' sparks new hard line: Enduring practice in the crosshairs ", Globe and Mail, April 5, 2004 - Page B1

B. What's happened in the U.S.?

A Sept. 1998 SEC report detailed just what some fund companies purchased with soft dollars. About 55 percent of the credits were used for stock-research reports, while an additional 14 percent for news services such as Bloomberg LP. The other uses varied widely, including computer hardware, software and portfolio management data. While the SEC allows computers to be purchased with soft dollars so long as they were used primarily for research, the 1998 report found one fund manager who spent soft dollars to buy a computer that was operated exclusively by his family, which used it to play video games. Other advisers, the SEC said, used soft dollars to pay telephone bills, rental-car costs, to install antistatic carpeting, and to buy theater tickets. Codes of ethics and annual certifications did not stop these abuses. The recent problems at Fidelity U.S. involve gifts from brokers to Fidelity traders.

In testimony March 23,2004 to the U.S. Senate Banking Committee, Robert Pozen, the new MFS Chairman asked for the SEC to return to severe restrictions on soft dollar transactions that existed before 1986. He wants the "addiction to extra charges" to end. In 1986 they were permitted only if a service "was not readily available for cash". Then deregulatory chairman, John S.R. Shad, lifted restrictions on how funds could use soft dollars that opened the door to abuses, such as brokers paying fund advisers' rent and cable-TV bills. MFS, a Sun Life Financial (SLF) mutual fund subsidiary, has stopped soft dollar transactions [but no word about what's to happen to SLF's Canadian funds]. SLF also owns 34 % of CI Fund Management Inc, Canada's second largest independent fund Company and they too have not articulated a definitive position on soft dollar trading, which potentially costs investors money. Why should American investors have better protections than Canadians?

Several U.S. firms employ a benchmark for measuring trading efficiency known as volume-weighted average price, or VWAP. The measure compares an individual trade against the average prices paid for that stock on that day, with bigger trades weighted more heavily. Using VWAP metrics, fund companies have channeled more and more business to the most skillful brokers. On in-house accounts fund companies have tied their trader's bonuses partly to performance measured by VWAP, shaking up the old system of awarding bonuses largely based on the subjective opinions of portfolio managers. Fund performance has increased as a result of the reduced commission costs.

C. Soft Dollars - a troubling practice

So what exactly are the concerns of investors? Here's are the main concerns:

1. Soft dollar transactions usually have inadequate documentation and a foggy paper trail. They are a masked expense that has the potential for skimming; it fails the smell test.
2. Can lead to hard-to detect abuses and unfair allocation of benefits to select mutual funds. Therefore, soft dollar transactions should be formally identified and disclosed in the Prospectus as an explicit risk of investing in mutual funds, if, despite the objections, the current practice is maintained.
3. Potentially increases fund costs that investors pay. We believe a diversion of energy to relentlessly bring down brokerage commissions will have a greater positive affect for investors than the resources expended today in utilizing, administering, monitoring and debating soft dollar transactions
4. May be breaching income tax Act by avoiding GST-could be considered a barter transaction. Perhaps more important is that a period expense, research, is being capitalized. This can, in effect, unduly affect income taxes properly payable. In effect the same cost element, research, is being treated in 2 different ways on the same financial statements.
5. It's simply bad accounting -it doesn't match costs to revenue (benefit) and research should be expensed not capitalized as part of the portfolio cost base.
6. Fund managers should be striving to obtain the lowest, responsive, responsible price for trade execution and disclose that they did so. Those brokers who come through should be rewarded with more business as part of a continuous improvement program.
7. Research is now readily available from multiple sources; some "independent research " in the past may in fact have been tainted
8. Limited audit trail and few tools exist to validate that the practice has a net positive cost-benefit for fund investors
9. Brokerage commissions, as Mutual funds assets, should not be used to line fund sponsor pockets, give the appearance of doing so or incur extra costs for ensuring that they do not do so
10. Trustees and Directors cannot readily monitor for compliance with fiduciary obligations
11. Can lead to higher portfolio turnover than necessary, adding to increased fund expenses and taxable capital gains for investors

12. when executing foreign market trades, such commissions could be used as a form of money laundering [we ignore here the issues and disclosure of undisclosed currency conversion fees that are related to brokerage transactions in international mutual funds]

An example cited by one respected fund analyst cites the case where a dealer could over commit on its soft dollar arrangements. This could cause conflicts if it traded accounts that did not benefit from the specific service paid for from its commissions or cut off dealers who would otherwise supply useful investment intelligence to the organization. The same analyst argues that someone paying cash for a service directly is likely to be a lot more hard- nosed about his spending than someone using commission dollars, which don't impact the fund company bottom line. It's entirely possible that some services are priced higher in soft dollars, which isn't good news for investors. A scenario of a soft dollar trade is presented in Attachment II.

D. Putting some numbers on the issue

According to research firm Greenwich Associates (www.greenwich.com) in 2002, U.S. mutual funds and other institutional investors paid about $12.7 billion in commissions, and about $4.5 billion (35.4 %) of that went toward research and other items purchased with soft dollars. Source: Summary of May 5, 2003 report "U.S. Equity Soft-Dollar Practices — U.S. Investors"

Using Greenwich's numbers and estimates that put total U.S. fund expense payments at $70 billion a year, adding soft dollars to expense ratios would cause the average to rise by 6 percent. For funds that trade stocks most rapidly, however, the disclosed expenses could more than double. Brokerage commissions are a cost to the fund but are not included in the MER. Soft dollar transactions abuse investors in that the true cost breakdown of operating the fund is not disclosed, costs are incurred for activities of no or questionable benefit to the fund and excessive costs are incurred due to higher brokerage fees /higher turnover rates.

The July, 2000 OSC 's *Final Report Mutual Fund Governance Cost-Benefit Analysis* (Section VI) authored by Keith A. Martin stated "…In Canada, it is estimated that a soft dollar transaction costs $0.06 per share compared with $0.03 per share for trades where soft dollar arrangements are not a factor…"

Soft dollar trading is a major issue in Canada with some estimates putting it as high as 25 % .An estimate by IE's Jean Murphy put the total value of brokerage commissions paid in 2002 by all equity-based funds — balanced, Canadian, U.S. and international — at $513.2 million, a 2.3% increase from the $501.6 million paid in 2001 but unchanged from the 2000 market peak. This is a lot of money. Once all the rationalizations are stripped away, the only defense we hear is that "this is the way it's always been done, and everyone else does it.". That's not good enough in this day and age.

E. Responses to Specific 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?

Investor advocates, such as myself, believe that the CSA should ban soft-dollar trades outright. As a absolute minimum the CSA should amend current policies to expressly exclude from the definition of "investment and decision-making services" the following: (1) computer hardware and software, databases and any other electronic communications facilities, used in connection with trading or investment decision-making; (2) publications, including books, periodicals, journals and electronic publications, that are available to the general public on a commercial basis; and (3) third-party research services, i.e., services provided or produced by a party other than the broker receiving the trading commissions and (4) seminars and associated travel/ accommodations.

If a fund manager wants to spend money on something, that cost should come out of the management fee. If a fund manager believes that access to certain research (or specialized software/databases, etc.) will result in superior investment returns, then he/she should by all means pay for it - this is precisely the type of expense that should be paid for out of the management fee.

At the very least, mutual fund managers should be required to disclose the amount of soft-dollar benefits they receive, item by item. For greater transparency, commission expenses should be disclosed in the annual fund financial statements with a breakout of any transactions between related parties. Fund managers shouldn't use soft dollars to buy anything that is "readily and customarily available and offered to the general public on a commercial basis" e.g. newspaper subscriptions, Bloomberg terminals, computer equipment, seminar fees and travel or entertainment costs etc. If fund managers need or want such materials, they should pay cash out of their own pockets, just like everyone else. Finally, managers should be required to spell out all soft-dollar arrangements in detail, in writing. and have documented internal control policies and procedures

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? As the market timing scandal has so clearly demonstrated, breaching principles of fiduciary duty were regarded by industry participants as ***not illegal***. So much for principles- based regulation. In the case of soft dollars, / best execution, a ban is our #1 choice but if a compromise must be made than prescriptive, enforceable rules need to be delineated. Brokerage commissions are an asset of a fund. Best execution is the most important factor and transparency is vitally important. These factors weigh strongly in favor of abandoning soft dollar arrangements involving mutual fund assets. Banning soft dollars reduces conflicts- of- interest, simplifies fund administration / governance and makes regulatory compliance monitoring easier. It also builds a better financial services industry.

Question 3: Do you believe that there are other elements of best execution that should be considered? If so, please describe them. We feel the main elements have been articulated. NASD rule 2320. Best Execution and Interpositioning provides a useful insight.

Question 4: If audit trail information is not in easily-accessible electronic form, how is the information used to measure execution quality? Is there other information that provides useful measurement? As we state over and over again, the best idea is to prohibit soft dollar transactions. If institutions want to measure best execution they should be free to do so.

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? We feel that real independent fund governance boards need to be put in place with powers and authority to implement meaningful fund governance.

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?

There does not appear to be readily available relevant academic or other research in Canada. Anecdotally, the issues appear, especially regarding related parties. On a philosophical and logical basis of course, conflicts- of- interest between the fund sponsor and the fund investors exist. Foreign securities trading involves higher commissions and currency conversion; a ban on soft dollars would not only reduce fund expenses but could also have positive side benefits regarding the management and visibility of money flows between Canada and foreign countries. We are unable to comment on the quality of execution issues surrounding derivatives trading .The issues surrounding bond commission/pricing transparency are well known and need not be rehashed here. Regulatory and industry action, not further study will finally eliminate the lack of transparency for fixed income debt securities.

An example from the U.S. illustrates how even passively managed products can be abused:

A U.S. report cites the Lionel Amron case. Amron is suing the folks who run Morgan Stanley S&P 500 Index fund, claiming that they are "grossly overcompensated" by the fees they earn from this fund. The fund carries a 1.50% expense ratio for the "B" shares of this index fund. He claims that more than 71% of the brokerage commissions of Morgan Stanley S&P 500 Index fund were used as soft-dollar payments to purchase third-party "research". Inasmuch as an index fund has no conceivable need for "research," and assuming that Amron's allegation is true, the managers of this fund were almost certainly enriching themselves at the expense of their shareholders.

Clearly, index funds and index ETF's should be prohibited from using soft dollars. The example also highlights how even reputable organizations can be led astray. Best to avoid the temptation. Indeed, index funds should be spending their time developing sophisticated strategies to get as close to the benchmarks as possible without frittering away money on trading.

Question 7: How should dealers in Canada monitor and measure the quality of executions received from foreign executing brokers? We think they can compare to a database; we understand such services are available. A very basic measure would be to use per-share rates from efficient electronic trading systems as the *encumbered –free* commission rate. Execution-only rates are easy to determine, they are rates that ECNs like Island, Archipelago, and Instinet offer for access to electronic markets. Anything above that benchmark is a measure of inefficiency or opportunity for improvement.

Question 8: Do you think that internalization of orders represents an impediment to obtaining best execution? We think that order execution for a mutual fund should go the lowest responsible, responsive providor whether internal or not. If internalized there should be current benchmarks defined and reported against. All commissions paid to related parties should be separately disclosed.

Question 9: Should there be requirements for dealers and advisers to obtain multiple quotes for OTC securities? Should there be a mark-up rule that would prohibit dealers from selling securities at an excessive mark-up from their acquisition cost (similar to National Association of Securities Dealers, Inc. (NASD) requirements dealing with fair prices)? We have no comment, as we believe this is a minor issue for most mutual fund investors. We add parenthetically that it may be useful to apply a legal limit on commissions Re OTC trades

Question 10: How is best execution tracked and demonstrated in a dealer market that does not have pre- or posttrade transparency such as the debt or unlisted equity market? No comment – we have no knowledge of the processes used. We do note however that bond funds (about $50B), balanced funds (about $80 B) and asset allocation funds involve billions of dollars in assets.

Question 11: How does an adviser ensure that its soft dollar arrangements are consistent with its general obligations to its clients? We believe soft dollar arrangements should be banned. Some of the ideas proposed by RBC in Attachment I may be useful if the practice is maintained in some form. It's a matter of documentation. monitoring and governance.

Question 12: Are there any other additional benefits or concerns with soft dollar arrangements that are not noted above? We feel we have articulated the primary investor concerns in Para C. above. Since we are skeptical regarding benefits and feel the Wharton paper [Reference 4] is on the mark we can cite no net benefits to investors. The recent market timing scandals with some of Canada's largest fund companies and increasing litigation have once again put into question whether sponsor and unitholder interests are aligned.

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? Whenever there is bundling, an alarm bell should go off. We offer a dozen reasons for doing away with soft-dollar trading in Para C. AND, we are not alone.

"I honestly think that soft dollars will not be able to stand the test of time this time around "

-Bill Holland, CEO, CI Fund Management Inc.
Source: W. Dabrowski, Financial Post, July 21, 2004 Pg. FP1

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? Disclosing the impact of brokerage fees on returns would give investors a better picture of how efficiently a fund is run. Low fees and expenses are a key determinant of fund performance. Additionally, this added level of disclosure would help investors and investment advisers better understand how fund managers operate. Low brokerage commissions would indicate a more conservative, buy-and-hold manager who seeks out quality stocks and bonds, while high commissions suggest a hard-trading market timer whose fund would be volatile and thus suitable for more aggressive investors. We feel the commission data should be included in the simplified prospectus and financial statements, in the section for each individual fund - Ratios and Supplemental Data. It would be very useful to have brokerage commissions calculated as a percentage of average fund assets, in the same way as almost all other fund expenses are normalized in the MER. Figures should be provided for the immediate past year and the previous 4 years.

We believe fund analysts, academics, regulators and law enforcement would also find the information useful. We add parenthetically that the **Summary of Portfolio Transactions** should continue to be made available on request to investors. Indeed, the format, content, font size and legibility should be prescribed and standardized by regulators.

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)? We are unable to comment on this. We can say that what investors basically want to know is ; *what are the all-in costs of owning this fund?* and *Is the fund management acting ethically and in my best interests?* Any regulations that satisfy this criteria is investor-friendly.

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? As we don't agree with soft dollars, we cannot answer this question as posed. In any event, investors really only need two numbers, the absolute commission dollars per fund and the normalized –to- fund assets statistic. The absolute figure should be mandated as part of the fund's external auditor mandate. We believe the tax Act would not permit the entire commission to be melded into operating expenses. A *nice to have* would be average costs in cents/share vs a benchmark-this could be in the AIF

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"? We do not think an "effective MER " needs to be calculated. We would prefer isolating the commission statistic as indicated in our response to Question 14. Keeping it simple will be in the best interests of investors and other users of the information. Besides, the resulting MER would be volatile and dependent on market conditions/trading strategies. Fund governance boards might want more detailed information and breakouts but we do not believe it need be part of a mandatory disclosure to the public.

Question 18: Should directed brokerage or commission recapture arrangements be limited or prohibited? Directed brokerage is yet another major issue for investors –it can lead to purchasing unduly expensive or unsuitable funds. Directed brokerage compromises the impartiality of advice It should be prohibited –fund managers should focus on earning the best return for the fund given its investment mandate and avoid all the game playing. IDA By Law 18.12 prohibits non-cash compensation like trips. National Instrument 81-105 prohibits the direct payment of cash or non-monetary benefits and prohibits any dealer from providing to its sales representatives a biased incentive to favour one mutual fund family over another. IDA Regulation 1300.1c (suitability) requires registrants to make recommendations to clients based on their suitability for the client.

Question 19: Should disclosure be required for directed brokerage or commission recapture arrangements? Again, as we don't support directed brokerage in principle, we cannot respond to this question. Disclosure of bad practices is not a solution. In fact disclosure could reduce investors legal posture in subsequent disputes or class actions.

Question 20*: *Would any of these initiatives be helpful in Canada? For every scandal that occurs in the U.S. a comparable Canadian scandal exists. We have Nortel, Bre-X, Livent, etc etc. and the mutual fund timing scandals too. We believe a lot of lessons learned in other geographies can and should be applied here and the faster the better.

F. Summary and Conclusion

Currently, fund unitholders are not only generally unaware that brokerage commissions are a separate charge, levied on top of the management expense ratio, but they are also unable to get helpful information on these hidden expenses. Alternative trading systems, enhanced information systems and improved technology are dramatically impacting the trading process for equities and bonds.

The U.S. experience suggests that we be on the lookout for "stretched" ideas of what *investment decision-making services* can become. Canadian laws are somewhat different but limited regulatory oversight may have let bad practices creep in. In the United States these have included PCs, Bloomberg terminals, satellite access, T1 datalinks, investment strategy seminars in exotic locales, dual- use services (can be used by specific fund, other funds in or outside the complex and the fund company itself), travel to companies for due diligence and lots more. We should learn from the experiences of others and tailor our best execution policies to the needs of Canadian mutual fund investors .A retired Bay Street fund exec called soft dollars " a toxic mixture of tied selling, bundled pricing and wink & nod procurement ". In any event, disclosure, no matter how detailed does not make a bad practice good.

Brokerage commissions are a cost to a fund- best execution is the most important factor and transparency is important. Prohibiting soft dollars would make it easier for investors to understand the costs of various investment advisory products and services. The commission breakout, the turnover ratio and the Statement of Portfolio Transactions would give good visibility to investors and fund analysts. This weighs strongly in favor of abandoning soft dollar arrangements involving mutual fund assets. Respected fund firm, Vanguard Funds, a successful low- cost U.S. fund company has never used soft dollars. High Canadian MER's and other fees should provide more than enough cash to provide all the necessary research. Such research is after all the raison d'etre of the portfolio manager.

Canadian fund companies admit soft dollar trading is used, but state they are fully compliant (whatever that means) with regulations. They claim that the mutual fund industry is staffed with well-supervised and trained ethical people that investors should implicitly trust. Maybe so, but the recent mutual fund market timing scandal has made "trust me " difficult to swallow. A review of the IDA settlement agreements indicates shocking behaviour and investor abuse on the part of 3 of Canada's leading brokerage houses. Imagine if fund auditors or custodians started a similar soft-dollar game for the extra services they could provide. Another aspect of the fund manager –broker relationship is front –running, a related but different issue. The TSX RS are no doubt trying to firm up the rules and surveillance. We disregard this aspect in this submission but many feel this is yet another conflict of interest that needs to be addressed by regulators.

We should remain mindful too that bank- owned mutual funds (and others like Dynamic, Caldwell and AIC) have related brokerage businesses (profit centers), and that bank mergers, vertical integration and industry consolidation are likely to further add to the scope and scale of the conflicts –of- interests dilemma.

All this complexity, cost, regulation, administration, disclosure AND bad perceptions - is it really worth it? Be done with the controversial practice, include all research related activities in the management fee where it belongs, and move on. This would make the interests of fund managers and fund investors better aligned. Discontinuing this practice should allow mutual funds, consistent with best execution and liquidity requirements, to increase trade with discount brokers and electronic exchanges and thereby reduce shareholder trading costs. Besides, some industry watchers claim stock research has become much more readily available. Eliminating the potential conflicts of interest will strengthen the operating integrity of mutual funds

"…Why do you all have to do it? Before, research was done to get underwriting. Now, you can't use it to get underwriting. It's become more like a commodity…"
-Glenn Cooper, eResearch (www.ersearch.ca)
Source: Hanley W., "The Home Depot of equity research ", FP MONEY, Aug. 28, 2004

Attachment III from Abel/Noser [http://www.abelnoser.com/] offers some additional insights on the topic as related to investment funds. N.Y. based Abel/Noser has long been respected as a leader in the campaign to lower the costs associated with trading.

They provide a range of effective tools and services for institutional sponsors and investment managers. Abel/Noser provides Transaction Cost Analysis in conjunction with other services that assist portfolio managers achieve cost savings. Their experiences are of value in the context of the current discussion. Attachment IV provides additional references on this important topic.

Of course, it doesn't matter what laws or regulations are in place, without continuous and diligent regulatory monitoring, enforcement and stiff penalties- anything can happen where so much money is involved. An idea of the scope and size of the penalties, sanctions and remedies for breaches should be delineated. The recent handling of the mutual fund market timing probe disturbed small investors because (a) the OSC abruptly stopped the probe after only 5 of 20 companies were prosecuted and (b) because the OSC did not impose any fines, sanctions or disgorgements despite the flagrant breach of fundamental fiduciary rules in the Securities Act. If and only if, wrist-slap penalties are avoided in future, exemptive relief is NIL or rare and enforcement probes are diligently pursued to conclusion, then all the effort in making more rules is worth the effort.

Should you require any additional information, do not hesitate to contact me.

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<u>Attachment I –RBC's stance</u>

As part of a package of reforms to restore unitholder confidence, RBC Funds made the following announcement in July, 2004 regarding tightened soft dollar policies:

"> We use soft dollars only for pure research services, a standard that is more restrictive than the Soft Dollar Standards recommended by the CFA Institute.

> We are committed to ensuring that commissions used for research are spent in the best interests of Fund unitholders.

> Soft dollars represent a very modest amount of our overall trading commissions. The annual soft dollar budget is reviewed and approved by our Chief Investment Officer and Chief Financial Officer.

> We monitor our trade executions to ensure all commissions, including soft dollar arrangements, are at competitive levels and satisfy our requirements to seek the best execution for all trades.

> Soft dollar policies are reviewed by the Audit Committee of the independent Board of Governors for the Funds.

> We believe that soft dollar commissions for research are, at present, important to maintain a level playing field between integrated institutional brokers (that provide "bundled" research and trade execution services) and the suppliers of independent

research who rely on soft dollar commissions to support their business model. We believe the promotion of high quality, independent research remains an important policy objective of regulators.

> We are committed to increasing the transparency and understanding of the soft dollar issue. Source: Update on Mutual fund industry Issues from RBC Asset Management (RBC AM), July 2004 http://www.rbcfunds.com/pdf/industry_issues.pdf

Per the July, 2004 RBC Funds AIF, the following companies provided investment decision-making services during the prior year in the nature of research, statistical and similar services to RBC AM in return for the allocation by RBC AM of portfolio transactions: Banc of America; Merrill Lynch, Thomas Weisel; Canaccord Capital; Wachovia Securities; Commission Direct Inc.; Scotia Capital Inc.; TD Securities Inc.; CIBC World Markets Inc.; UBS Warburg Inc.; The Bear Stearns Co. Inc; SG Cowan Securities Inc., Fano Securities, E*Trade (TIR) HK, William O'Neil & Co. Incorporated, Catalyst Research Corporation and Veritas Research Corporation. Quite a soft dollar list and a lot of records to keep and actions to justify.

Attachment II -The real world soft dollar trading process

A January, 2003 article *You only pay twice: Soft-dollar deals between brokers and fund managers are under fire south of the border. Why not here?* by Doug Steiner at globeadvisor.com [ADVISOR FOCUS] makes the issues abundantly clear. We quote directly---

"Let's walk through a best execution dilemma. Your portfolio manager, David, gets a hankering to buy Cogeco Cable, an illiquid stock you need a searchlight to trade. He wants 1.2 million shares. Cogeco Cable normally trades about 30,000 shares a day. The idea came from Tiny, Little and Insignificant, an investment boutique run by a couple of ex-$2-million-dollar-a-year research analysts who set up their own shop. David wants to pay them a commission of four cents per share--high, but not outrageous. That's $48,000 for the trade.

But David is also aware that Tiny, Little and Insignificant will butcher the trade. The trading desk is too small to get calls answered, and a badly executed order will lift Cogeco Cable by, say, $4 per share. Griffiths McBurney & Partners is the big-volume trader in Cogeco, but David is still mad at them because he got a lousy allocation on a hot IPO a few months ago. There goes best execution. Instead, David gives a less-hard-to-butcher trade to Tiny, Little: buying a million shares of Nortel, which an eight-month-old baby bashing an order entry keyboard couldn't screw up because the stock is so liquid.

David decides to do a soft-dollar trade with the Cogeco order because his boss is on his back to pay some bills. David gives the trade to a bank-owned dealer. The dealer takes the trade at five cents a share, and agrees to pay some of the fund company's bills with four out of every five cents. The remaining penny a share is fine because the dealer assumes that the seller with whom he matches the trade will pay the full freight.

This helps David. His firm saves money. The five-cent commission is included in the share price, which ultimately lowers returns to unitholders. But it's not included in the fund's management expense ratio (MER), the cost figures that investors look at.

The dealer turns around and pays, say, $1,200 for risk measurement services and $3,050 to another research firm for analyzing bank credit. It cuts a $6,000 cheque to someone to analyze risk. It sends $2,200 to pay for the fund's newspapers for the year. A saleslady picks up an $8,500 cheque for the fund's quote machine. And so on, and so on. The money's not all spent, so the dealer "banks" the balance, awaiting phone calls from the fund company to pay more bills. This is all legal if it's done for the benefit of unitholders. The amount paid in soft dollars is not reported. Investment companies will argue that soft dollars help keep MERs down, but who's kidding whom? Fees generally go one way in this business--up, up, up…" Source: www.globeadvisor.com

<u>Attachment III Abel /Noser response to SEC Mutual Fund Transaction Costs</u>

Abel/Noser

Member, NYSE and SIPC

Eugene A. Noser, Jr.

President

Abel/Noser Corp.

90 Broad Street

New York, NY 10004

February 23, 2004

Mr. Jonathan G. Katz

Secretary

U.S. Securities and Exchange Commission

450 Fifth Street, NW

Washington, D.C. 20549-0609

Re: Concept Release: Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs; File No. S7-29-03

Dear Mr. Katz:

Abel/Noser Corp., a member of the New York Stock Exchange and other leading exchanges, has long been respected as a leader in the campaign to lower the costs associated with trading. To that end, we provide a range of effective tools and services for institutional sponsors and investment managers. Abel/Noser provides Transaction Cost Analysis in conjunction with other services that help our clients achieve savings.

Abel/Noser Corp. provides Trade Cost Analysis services to over 400 institutional investors, including many of the largest mutual fund companies in the world. We evaluate over $4 trillion of institutional trading data annually. Our universe of institutional trading statistics includes information from over 500 separate investment advisors representing over 750 portfolio manager managers, including some of the largest global money managers. Using a combination of strike price and volume weighted average price measures we have developed investment style trading cost benchmarks that allow institutional plan sponsors and mutual fund directors to make relevant cost comparisons between investment advisors. We welcome the opportunity to comment on proposals to publish trading cost information in mutual fund disclosure documents.

Commissions Matter

Every officer of a defined benefit plan or mutual fund has an obligation to ensure that all actions taken by the plan are in the best interest of the beneficiaries. Our plan sponsor clients first concern is to ensure that their investment managers make hard-nosed decisions regarding the disposal of plan beneficiaries' commissions. To that end, they monitor explicit commission expenses by market and compare them to benchmarks derived from our universe. This enables plan sponsors to ask their managers meaningful questions when results deviate significantly from expectations. Mutual fund investors should be able to look at similar statistics for the funds where they invest. Each quarter, a fund could publish total commission expenses by exchange in dollars, cents per share and basis points. The funds could also state these costs as a percentage of assets under management on an average basis. This latter statistic would sum up turnover as an input to commission costs.

The section 28(e) safe-harbor enables investment advisors to acquire independent investment analysis through the use of "soft-dollars." Soft-dollar practices are not in and of themselves wrong, but they are subject to abuse by corrupt practitioners. Many of our clients demand that their investment advisors provide them with information regarding the uses of commission payments that exceed "execution-only" rates, that is, the rate that would pay for trade execution alone. Execution-only rates are easy to determine, they are rates that ECNs like Island, Archipelago, and Instinet offer for access to electronic markets.

The commission should also require that Mutual funds disclose the commission payments in dollars, cents per share and basis points for different types of commission payments. These types of payments should include, proprietary research, independent research, sales of fund shares by the brokerage, and services such as market data or statistical services. Furthermore, fund advisors should disclose the extent to which they fund investment operations out of advisory fees.

Transaction Costs Matter, Too

The conversation becomes more recondite when our clients turn their attention to implicit transaction costs. We usually provide pension sponsors with results of three measures: the market opening price, the daily volume weighted average price and a volume weighted average price for a five-day time period centered on trade-day. Our mutual fund clients also use combinations of strike prices and volume weighted average prices to evaluate trades that extend over more than one day.

Strike Prices

Strike prices are prices that represent the prevailing market price at a specific instant. The strike price reveals the direction of the prevailing market trend during the time the manager executes a trade. Strike price measurement results are influenced largely by the mechanical workings of the market. Strike price measures reveal mechanical characteristics of the measurement method.

The open price serves as a reasonably useful proxy for the price that might have prevailed when the investment advisor decided to enter an order to trade. The difference between the open and the actual execution price represents a gain or loss enjoyed by the investor. The result versus the open price reveals information about the market conditions under which investment advisors complete their trades. Investors who prefer to buy rising stocks and sell falling stocks will incur higher costs than investment advisors who do the reverse. Neither strategy can be proven to offer an advantage to investors.

Spread Costs

Published spreads fluctuate constantly. Published spreads offer only a hint of available liquidity at given prices. Market participants seldom publish their trade intentions to trade to the world. Often, traders can submit bids or offers, provide liquidity, and capture the theoretical spread as a trading profit. Funds might publish an average spread for the stocks they trade, but we do not know of a generally accepted source of such information.

Volume Weighted Average Price

The daily volume weighted average price measure reveals a manager's ability to achieve reasonable executions compared to other simultaneous investors. We believe this measure offers a useful indication of a manager's ability to achieve "best execution." The difference between the trader's execution price and the volume weighted average price removes the market movement from the trading cost calculation. Many practitioners accept that volume weighted average price measures provide insight into execution quality. We suggest that volume weighted average price measurement results can be used as a reasonable estimate of spread costs. Documents could express costs in dollars, cents per share, basis points, and as a percentage of assets under management.

Unfortunately, the volume weighted average price measure is unpopular with many investment advisors because of a perception that their traders will fail to execute unfavorable trades in an attempt to "game" the measure. This argument assumes that traders will sabotage an investment idea in the pursuit of a better trade measurement result. Our experience tells us that no trader could play these games for very long. We believe that one can level the same "gaming" criticism at any measurement scheme that relies on reference prices that traders can deduce at the time of the trade. But these reference prices provide the most meaningful information about an investor's ability to implement their strategies and compete with other investors.

Opportunity Cost

Opportunity cost is defined as "the road not taken" in investment. An order that the manager does not fulfill to his satisfaction contains an element of opportunity cost: the gain that the investor had to forgo by failing to achieve an ideal investment. One could calculate opportunity cost as the subsequent performance of shares not bought. Several problems arise in capturing the data Portfolio managers may not reveal orders in a way that the firm can record. Portfolio managers with competing orders in the same fund family may enter larger orders than they require with some expectation that they won't get all the shares they request. Little mention is made of losses avoided, or the performance of dollars put to work elsewhere, but these would have to be taken into account in an accurate opportunity cost computation.

Trade Effect

The trade effect measure discussed in the concept release relies on strike prices after the trade to evaluate trading effectiveness. Like pre-trade strike prices, measurement results will overwhelmingly depend on market movement beyond the scope of the trader's skills. Little information is offered by looking at trades one or two days hence. An alternative trade effect measure would compare the active portfolio performance to the performance of the original portfolio held at the beginning of the measurement period. This would illustrate the effect of decisions to buy and sell securities versus a simple "buy and hold" strategy. We believe this simple analysis could be accomplished with fewer burdens on the investment manager and is easier for the investor to understand.

Conclusion

No single measure can reveal all the issues that surround the notion of "trading costs." However, we believe that the measure mentioned above, which reveals performance versus the investment advisors' original static portfolio, captures most of the value of decisions to buy and sell securities over the investment period.

Managers will find it very difficult to estimate trading costs. They will also face the inevitable conflict that will result from wanting to appear to minimize those costs in disclosure documents. Investment managers would have to adopt a uniform set of data acquisition techniques in order to provide the level of specific trade cost data that this concept release contemplates. Stringent data acquisition requirements could be onerous to small investment advisors, putting them at a disadvantage to large investment advisors. Also, uniform transaction cost reporting requires a universally accepted methodology for measuring costs. So far, this methodology does not exist in practice.

We thank the commission for the opportunity to comment on the proposed rules and hope you find our comments useful. If you would like to learn more about our experience providing transaction cost analysis to institutions, please contact me at 212-344-2610.

Sincerely,

Eugene A. Noser, Jr.

President

Attachment IV Some Applicable References

(1) A July, 2004 report "*Best Practices and Practical Guidance for Mutual Fund Directors*", by the Mutual Fund Directors Forum www.mfdf.com, done at the request of SEC Chairman William H. Donaldson, recommended a ban on soft-dollar commissions, citing potential conflicts of interest between the adviser and the fund. The Washington based Forum, a non-profit organization of fund directors unaffiliated with their funds' advisers, said one estimate put the soft-dollar market for investment research and related services at more than $1 billion USD. Soft-dollar arrangements raise questions, the report said. Was the trade allocated to a broker-dealer based on research the adviser receives rather than the quality of execution provided to the fund? Could a lower commission have been paid if the adviser hadn't received the research? Did the need for research prompt the adviser to place trades it might not otherwise have placed? Are other funds or clients of the adviser unfairly benefiting from research a fund's trades pay for?

(2) The OSC Compliance Team's 2003 Annual Report. notes that OSC staff identified issues with respect to soft dollars, conflicts- of- interest and best price and execution (among other issues). It declared the need for better documentation on the selection process for broker services, written guidelines on the use of soft dollars and improved books and records. The Report further recommended that a list of all soft-dollar arrangements be maintained. This list should include the name of the broker or other entity involved, the nature of the goods or services received by the Registrant and the approximate annual amount of commissions on securities transactions needed to satisfy each arrangement. The report also stated that as part of the process of adequately monitoring portfolio sub- advisors, the due diligence of market participants should include assessing the adequacy of the subadvisor's internal policies in the area of "soft dollar" arrangements.

(3) In proposed rule NI81-107 *Mutual Fund Governance*, the CSA is suggesting that "soft dollar" transactions he regulated as a business conflict- of interest matter by a mutual fund's Independent Review Committee, a toothless group of individuals. NI81-107 has been critiqued by SIPA, CARP, fund analysts, personal finance journalists and others as providing a wholly inadequate level of investor protection. We would certainly oppose any attempt to use IRC's as adjudicators. Why not just eliminate the conflict-of- interest rather than construct an elaborate mechanism to monitor it?

(4) An August 2004 Wharton School study ***Caught Between Two Principals* by** Nicolaj Siggelkow found that U.S. mutual fund providers shift advertising expenses via 12b-1 fees and research expenses via soft dollars (excess commissions paid by fund providers) on to fund shareholders. The study found no evidence that excess payments of brokerage commissions (soft dollars) are used to lower the explicit research fees that fund providers charge. According to the author these results suggest that, at a minimum, soft dollar

arrangements should be made more transparent. Expense shifting is much more pronounced for retail funds than for institutional funds, while it is much less affected by competition among fund providers. Bottom line: after examining thousands of funds, Siggelkow concluded that fund managers *do* exploit opportunities to maximize fees, often using techniques that make fees virtually invisible to investors. The paper is available at http://knowledge.wharton.upenn.edu/papers/1280.pdf

(5) In March 23, 2004 testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, Mercer Bullard President of Fund Democracy, Inc. said:

"The Commission's partial expense ratio also distorts managers. behavior because it creates an incentive for them to pay for non-execution expenses with fund commissions. Under current law, fund managers can payer higher commissions. that is, more than it would cost merely to execute the fund's trades in return for non-execution services. By paying for these non-execution services with commissions, or what are known as soft dollars, fund managers effectively move these costs out of the expense ratio where they belong. This enables the fund that uses soft dollars to show a lower partial expense ratio than a fund that does not even if the fund managers use identical services and have identical operating expenses. The Commission itself has conceded that. [t] he limited transparency of soft dollar commissions may provide incentives for managers to misuse soft dollar services. [30] Furthermore, the nondisclosure of portfolio transaction costs exacerbates the conflict of interest that is inherent in the payment of soft dollars. As the Commission has recognized,

. [s] oft dollar arrangements create incentives for fund advisers to (i) direct fund brokerage based on the research provided to the adviser rather than the quality of execution provided to the fund, (ii) forego opportunities to recapture brokerage costs for the benefit of the fund, and (iii) cause the fund to overtrade its portfolio to fulfill the adviser's soft dollar commitments to brokers. [31] 31 Donaldson Memorandum at 36, supra note 24. Regarding directed brokerage, the Commission recently stated: .We believe that the way brokerage has been used to pay for distribution involves unmanageable conflicts of interest that may harm funds and fund shareholders. Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Rel. No. 26356 at Part II (Feb. 24, 2004). .

While certain aspects of U.S. regulations and Canadian regulations are different, there is no question that since *best execution* is so difficult to measure a wide number of abuses using soft dollars can easily infest a mutual fund. A copy of his insightful presentation is available at
http://www.funddemocracy.com/Senate%20Banking%20Testimony%203.23.04.pdf