May 5, 2005

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

Dear Commissioners:

Russell Investment Group ("Russell") welcomes the opportunity to comment on concept paper 23-402, best execution and soft dollar arrangements.

Our response below represents a unique perspective on markets. First and foremost, Russell's perspective is that of a sophisticated user of investment manager and broker services. We currently manage roughly 150 multi-manager funds, totaling more than C$157 billion in assets globally. We employ 140 external investment management firms, covering asset classes and mandates ranging from traditional large cap equities and fixed income to emerging market debt, private equity and hedge funds. We make direct use of more than 40 brokerage firms for equities, fixed income, currencies and derivatives trading. In addition, Russell has various legal entities acting as investment adviser or broker dealer in many countries, is a leading global provider of commission recapture services and is a leading consultant in Canada and globally.

Our response has been structured around the specific questions raised in the concept paper, although we have not attempted to answer in full every one of the questions asked. We have raised only the points we consider to be the most important and those on which we feel best qualified to comment.

We would be happy to clarify or expand any aspect of our response, or to comment on those areas that we have not covered, should the Commission wish.

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?

We welcome the Commission's review of this area. Understanding of best execution, the nature of markets and trading practices all evolve over time. Regulation must also evolve to continue to create a structure that protects investors and encourages competition and

best practices. Our thoughts on the specific changes raised in the concept paper are addressed in our responses to later questions, but we would encourage the Commission to aim for a best execution requirement in Canada which:

a) recognizes that best execution is a process, not an outcome. Far from being a vague concept that gives the regulators nothing to work with in practice, the idea of best execution as a process is a stronger approach than that of best execution as an outcome. Further, investment managers should welcome an approach which uses a yardstick that is under their control (they can hope to control a trading process, but it is impossible to control an outcome).

b) is consistent with international requirements. With investment a global business, such consistency leads to more effective regulation and to greater efficiency.

c) is able to cope with market evolution. Charles Darwin is credited with the observation that: “It is not the strongest of the species that survives, nor the most intelligent, but the one most responsive to change”. The same can be said of good regulation; a structure which allows occasional, effective response to changes in the market environment is surely better than one which gets locked into one point in time.

The main forces for improvement of execution quality are competition, investor awareness and disclosure. Good regulation should aim to foster each of these forces.

Education

We strongly believe that client awareness of best execution and trading costs needs to be enhanced.

A process-based best execution requirement with clear principles, specific guidelines and strong disclosure will achieve the best long term results, but demands a certain level of understanding and involvement from investors.

Russell strongly supports the principle, set out in the Myners Code in the UK, that trustees (or those to whom they have delegated the task):

> *should have a full understanding of the transaction-related costs they incur, including commissions.*

While the Code applies specifically to pension plans, we believe that this principle is more widely applicable.

We have been actively involved in assisting our clients to understand trading costs. Specific examples of our efforts to help clients on this front include a *New Trustee’s Guide To: Trading Costs* and the work we did towards the creation of the *T Standard* (an

objective performance standard for transition management). We have included electronic versions of these documents with the e-mail version of this response.

Our efforts are motivated largely by the view that, while good regulation helps, investors ultimately cannot count on regulation alone to protect their interests. They have a duty to demand relevant information, to make use of the available disclosures and to develop an understanding of the cost being incurred by their funds, especially those costs which are not explicit but which are only captured within the performance numbers.

These efforts have been directed mainly towards the institutional market. The same principles apply to the individual investor market, although their application would be different.

Questions 2-5:
Should there be more prescriptive rules than those which currently exist for best execution or should the methods for meeting the best execution obligations be left to the discretion of registrants?

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

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?

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?

Prescriptive rules can impede innovation and limit competition. Regulation should be focused on fostering best practices and disclosure.

We strongly believe that best execution is a process, not an outcome.

It is impossible to completely control the outcome and a poor outcome can arise even where a process is sound.

For example, an investment manager may be keen to get out of a position in her portfolio quickly and send a sell order to a broker before the start of trading, with instructions to trade as close as possible to the open. The broker may do so and then find that the price of the stock rises throughout the day. The manager and the broker have achieved best execution because the trade was made in the way best aligned with the portfolio objectives, even though it turns out that the worst price of the day was obtained.

In contrast, poor processes can sometimes produce good outcomes.

For example, a manager may negotiate a principal bid with a broker. Despite efforts to disguise the exact holdings by providing only broad characteristics, the broker may manage to identify some of the names involved in the trade from the information supplied. That broker may pre-hedge his position, buying the stocks involved in his own book in advance of the trade. It may turn out in this circumstance that prices happen to move in the manager's favor and she may obtain the best price of the day. Nonetheless, we would not regard this process as providing best execution because the broker's activity can affect prices to the detriment of the client.

An analogy we often use to illustrate this point is that of a roulette wheel. A bet on red may return $2 for each $1 staked, but the odds of winning are less than 50%. The outcome of a given spin may well be red, and indeed even a prolonged series of gambles may produce a positive outcome. Nonetheless, judged as a process, the decision to gamble is bad. It is bad because of the odds; the process fails more often than not. Likewise, best execution is best looked at in terms of the underlying process, not of the case-by-case outcome.

We therefore agree with the statement in the concept paper that: "In practice, the best execution requirement is met by seeking to achieve this best net result and not necessarily by meeting an absolute standard." We believe that this should also be reflected directly in the definition of best execution. The proposed description at present is that "best execution means the best net result for the client, considering the relevant elements (including price, speed of execution, certainty of execution, and total transaction cost) in light of the client's stated investment objectives." This implies that best execution is an outcome. It is not.

Our own suggestion would be that the definition used in the CFA Institute's Trade Management Guidelines should be adopted. This is:

> *the trading process Firms apply that seeks to maximize the value of a client's portfolio within the client's stated investment objectives and constraints.*

The guidelines go on to explain that best execution:

- is intrinsically tied to portfolio decision value and cannot be evaluated independently,

- is a prospective, statistical and qualitative concept that cannot be known with certainty *ex ante*,

- has aspects that may be measured and analyzed over time on an *ex post* basis, even though such measurement on a trade-by-trade basis may not be meaningful in isolation, and

- is interwoven into complicated, repetitive and continuing practices and relationships.

The second of these points explicitly highlights that the definition is statistical in nature. Importantly, however, the third point balances this with the observation that outcomes are not irrelevant.

One example of how outcomes can be measured is provided by a recent Russell Viewpoint, *It's Time For More Choice in FX*, a copy of which is attached to the e-mail version of this response. This also provides important insights into the potential effect of a lack of investor awareness.

The Viewpoint presents the results of research into the execution of foreign exchange transactions for eight large investors, with four different base currencies (US dollar, Canadian dollar, pound sterling and euro). In all, more than 36,000 trades were analyzed. The quality of execution varied to an astonishing degree, with some investment mandates experiencing competitive execution and others systematically obtaining the worst price of the day. Investment performance was significantly impacted in many cases. This is an example of the use of monitoring to provide insight into a trading process and to identify shortcomings.

The CFA Institute's definition, while not yet explicitly incorporated into any country's regulation, is widely recognized and referred to. It is fast becoming the global standard for investment managers. We believe the principles it sets out can be applied to brokers also.

At present, best execution requirements for brokers are largely looked at in terms of outcomes. This appears to be necessary when one considers that the broker does not have an ongoing relationship with the end client, so it makes little apparent sense to talk about repetitive processes. Neither does he know the portfolio context of any given trade.

However, while the circumstances in which the broker is acting are different, the acid test of whether he is achieving best execution or not continues to be the process by which he is handling trades. In this respect, a parallel can be drawn with prudence and negligence which, when tested in the courts, use the outcome as a possible indication of failure and as a measure of the extent of loss involved, but not as final definitive proof. Best execution, like prudence, is a process not an outcome.

It follows from the view that best execution is a process that it cannot be precisely measured or quantitatively tested. We must therefore address the comment in the concept paper that: "One crucial aspect to consider is the ability to test compliance after the fact. An important factor is whether there are adequate methods for measurement …"

As we have mentioned above, monitoring is important and one requirement that should be specified as an intrinsic part of any best execution process is an appropriate program of monitoring of outcomes. From an investment manager's perspective, this requirement is described in section 1C of the CFA Institute's Trade Management Guidelines. We

would note that the prescription of particular measures could do more harm than good as practices change to game the measure rather than to produce the best outcome for the client. Instead, investment managers and brokers should each be required to create programs appropriate to their own circumstances, as described in those Guidelines.

Furthermore, clear guidelines should be issued and periodically updated. While we believe that attempts to create a totally prescriptive regime would inhibit innovation and restrict competition, rules and guidelines are nonetheless needed so that investment managers and brokers know where they stand, and so that the Commission has a vehicle to communicate their views on what specific aspects of trading processes are or are not regarded as consistent with best execution. This could be done as it is in the US, where, as described in footnote 9 of the concept paper "the SEC adopt an illustrative list of what items would be included or excluded from the definition of 'research services' and from time to time publish a new list or other interpretive assistance." Such an approach has the added advantage of being easily adaptable to new developments in markets or trading practices.

This approach is suitable not only for defining permitted and non-permitted services under soft dollar arrangements, but also permitted and non-permitted practices within the broader best execution requirement. Certain practices are simply incompatible with best execution; others are compatible only in certain circumstances, and so on. To the extent these guidelines can be produced in a way which can be updated in response to evolving circumstances, the regulatory regime is immediately made more effective, responsive and relevant.

Questions 6-10:
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?

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

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

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)?

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?

We prefer to leave detailed comment on these points to others, but would make the following observations:

1. that, while market fragmentation creates challenges (such as making price discovery more complex and raising issues for measurement) it is in general a good thing for investors. Competition is good. Choice is good.

2. that, consistent with our response above that best execution is a process not an outcome (and that a requirement for simple measurement should not be given primacy over the requirement for a definition of best execution that is aligned with client interests), the monitoring and measurement of foreign trades, debt, or unlisted equities is, in essence, no different than the monitoring and measurement of large cap domestic equity brokers.

3. on the specific question of internalization, we believe that internalization can be an impediment to best execution in some circumstances and that stronger safeguards are needed to protect client interests.

Questions 11-17:
How does an adviser ensure that its soft dollar arrangements are consistent with its general obligations to its clients?

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

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?

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 National instrument 81-106? Should the disclosure requirements be the same for third party soft dollar payments and bundled commissions?

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)?

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?

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"?

The essence of the problem is this:

1. That trading costs come in many forms. For example, the cost of trading in a principal trade is fully rolled into the price obtained and hence not objectively measurable (other than approximately). In an agency trade, part of the cost is commission and part of the cost is in the price.

2. If different forms of cost are treated differently, an incentive may be created to trade in certain ways, even if that does not produce a better outcome for the client. For example, if commission costs are included in the MER, but the cost of a principal trade is not, mutual fund managers have an incentive to favor principal trading. Similarly, if third party soft dollar arrangements are disclosed but bundled services are not, independent research is discouraged.

3. Explicit costs are intrinsically easier to monitor and manage than implicit costs which are, by their very nature, not known. If an environment is created in which implicit cost structures are encouraged, an illusion of disclosure is created yet the reality is that costs become more opaque and likely less well managed.

4. One might conclude from this that because implicit costs cannot (by their very nature) be disclosed, it is counter-productive to require explicit costs to be. It is difficult, however, to accept a conclusion *against* better disclosure. Investors have a right to know how their money is being managed.

We appear to reach an impasse.

Our view is that disclosure should be improved, but that care should be taken about how this is done. In particular, note that:

- trading costs are more closely related to fund performance than they are to operating expenses and investors should be encouraged to look at trading costs in the context of the portfolio management decisions that produced the costs.

- managing a single aspect of cost (be it soft dollars, commission or anything else) is not an end in itself and investors should not be encouraged to focus exclusively on any one type of cost, neither should the form of disclosure give an incentive to trade with any objective in mind other than the maximization of client wealth.

- the lessons of the debt market – where commissions are generally zero but bundling of services is nonetheless extensive – should always be borne in mind when framing regulation.

- the split between order execution and the other services provided in return for commission cannot be measured precisely. This follows from the very nature of bundling. Consider the following very simple example:

Suppose one product is sold for $5 and another for $3. However, they can be purchased together for $7. There is no objective answer to the question "if you buy the bundle, how much are you paying for the second product?": it might be any amount from $2 to $3. In exactly the same way, the amount of commission paying for non-execution services might be anything from a tiny percentage to the great majority of the commission cost, but there is no objective answer to the question. It is conceivable that reasonable, subjective estimates might be possible for managers, but this exercise is made much more difficult – and possibly meaningless - by the fact that they will probably have an incentive to minimize the amount they ascribe to non-execution services.

Questions 18-19:
Should directed brokerage or commission recapture arrangements be limited or prohibited?

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

Directed Brokerage

As noted in the concept paper, there are different types of directed brokerage. The principles governing these arrangements are no different than those governing any other service provided by a broker to an investment manager. Most importantly, as noted in the concept paper "when any factor other than the quality of execution is the primary reason for choosing a dealer, then the duty of best execution has been compromised". This area is particularly sensitive because of the financial impact that can result to the investment manager, and hence the substantial scope for material conflicts of interest. Parallels with affiliated trading can be drawn: an outright ban is not necessarily appropriate, but there is a strong duty on the investment manager to demonstrate that quality of execution is not being compromised.

The Commission should continue to make it clear that directed brokerage arrangements must be subject at all times to best execution (defined as a process seeking to maximize of client portfolio value) and that managers must be able to demonstrate how this is being achieved and how any conflicts of interest are being managed and disclosed to clients. Where practices emerge which appear to represent unacceptable conflicts (such as the

direction of transactions as inducement or reward for mutual fund sales) they should be explicitly banned.

Commission Recapture

Likewise, commission recapture should be subject at all times to the best execution requirement. Importantly, the direct financial benefit from commission recapture accrues to the client, not to the investment manager making the trading decision. As a result, the conflict of interest that easily arises under directed brokerage arrangements does not normally arise for commission recapture. Even so, it is essential that investment managers handle commission recapture requests within the context of best execution requirements. If the nature of a client request compromises, in the manager's view, her ability to achieve best execution, steps must be taken to correct that position (for example, by reducing the target recapture amounts or in extreme cases by declining to participate in the program).

The requirement on an investment manager when it comes to commission recapture is in fact the same as in any other aspect of the trading process: to build a program designed to get the best return on the client's assets and to be able to explain how they are doing so.

So, for a manager to participate in a commission recapture programme, she must first make an assessment that best execution is not compromised by doing so. Are the trading choices offered by that programme of a high enough quality? Is the level of participation that is being requested reasonable? Is the programme flexible enough?

A manager who does *not* participate in a programme has a similar duty. This manager must be prepared to state why she believes that there is no scope for rebates to be negotiated for the client's benefit.

Russell is a leading provider of commission recapture services in Canada and globally and, as such, we have strong views on the benefits of these arrangements as well as on the necessary steps that must be taken to ensure that commission recapture does not compromise a client's best execution.

Our response to the specific issues raised in the concept paper is as follows. We would note that our context here is the institutional market, since that is the market in which the great majority of commission recapture takes place.

- does commission recapture indicate that clients have been paying higher commissions than necessary? To some extent, this could be true. (Although we would note that the ability of customers to negotiate prices is in general associated with efficient markets, rather than inefficient ones.). Whether it is true or not, commission recapture is not the cause of the excess commissions, but a response to it – a response which directly benefits the end client. Whether it is a symptom or not of excessive commissions, it is not a cause. It is, indeed, part of the cure.

- is commission recapture the same as soft dollars? Commission recapture dollars may only be spent on services or expenses that could otherwise be paid directly with fund assets and their use is decided directly by the client. The end result is therefore identical whether they are returned to the fund or used to pay expenses that would otherwise be paid for with fund assets. In contrast, soft dollars are generally used to pay for services that a client would NOT pay for directly, and their use is decided by the investment manager. The two situations are quite different.

- does commission recapture compromise a manager's ability to achieve best execution? If commission recapture cannot be handled within the context of best execution, a manager should not participate in the program. There are some managers whose investment and trading processes are indeed incompatible with commission recapture. Such managers should not be expected to participate in a commission recapture arrangement.

We would also make the observation that, in the UK, the FSA commissioned research by Oxford Economic Research Associates (OXERA) as part of their analysis for CP176. OXERA's report was published alongside the Consultation Paper. The report notes that:

> *"In contrast to a soft commission arrangement, a directed brokerage arrangement does not involve a potential conflict between the interest of the fund manager and the client because the client, not the fund manager, is receiving the rebates directly." (para. 258)*

(Note that they use the term "directed brokerage" to refer to what the concept paper calls commission recapture).

Having examined the logic behind commission recapture, they go on to conclude:

> *"Thus, from the point of view of analyzing bundling and soft commissions, directed brokerage in fact has some beneficial effects, in that it allows large pensions funds to exercise their buyer power and reduce commission costs. In other words, pension funds are able to obtain their own part of the pie (commission rebates) which otherwise would flow to fund managers through soft commission arrangements." (para. 261)*

Investors in aggregate are better off because of commission recapture.

Finally, in response to the question of disclosure, we strongly advocate full disclosure of both directed brokerage and commission recapture arrangements, and our reporting is designed to achieve this. In the case of commission recapture, indeed, it is our experience that the reporting received as part of the program significantly improves the quality of disclosure received by the client about their overall commission costs.

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

A growing proportion of Canadian investors' assets are invested outside the country, and a growing proportion of assets in Canada are held by non-Canadian investors. Major market players are a mixture of domestic and external providers (mainly but not exclusively US). Therefore, while Canada is a significant market, there is much to gain by creating a market structure that operates well in the context of global practices.

The UK consultation process in connection with best execution and, in particular, soft commission and bundling has been exhaustive. We suspect that the responses to concept paper 23-402 will in general be more thorough and better-thought-out than they would be had CP154 and CP176 not been issued.

Most importantly, it is right that Canada should closely observe developments within the US. Clearly, the objective should not be simply to mimic the large neighbor. However, action taken in Canada should not be taken without consideration of how that action will interact with actions taken in the US. For example, suppose Canada were to ban the provision through soft dollars of a particular service permitted in the US, and the US to ban a different service permitted in Canada. Firms with a presence in both countries may be able to pick and choose what they receive where, and in effect circumvent both sets of regulation.

Being a global firm with 20 years presence in Canada and substantial market presence across a number of business areas, our suggestions above (for example, that the CFA Institute's definition of best execution be adopted in Canada) have all been made in the context of a wider view.

Yours Sincerely,

Bob Collie
Director, Research & Strategy