To: John Stevenson, Secretary
Ontario Securities Commission

From: BNY Securities Group

Date: May 6, 2005

Subject: Comments Regarding Concept Paper 23-402

We appreciate the opportunity to respond to the OSC Request for Comments on Concept Paper 23-402 "Best Execution and Soft Dollar Arrangements." In this paper we hope to address both soft dollar (third party) and bundled (proprietary) commission arrangements as delineated and defined in the concept paper. More specifically we would suggest that the best guidelines are those that encourage greater transparency and disclosure in the reporting of soft dollar and bundled commissions.

In this response we will occasionally reference the Bank of New York's response to FSA Consultation Paper 176. We believe that the topics addressed in 23-402 are similar to those addressed by the FSA in 2003-2004 in regards to soft dollar and bundled commissions. Please find full versions of our response to FSA Consultation Paper 176 and PS0423 to follow this response.

The Bank of New York

The Bank of New York, through a number of entities in the BNY Securities sector, is committed to providing institutional clients, such as investment advisors, institutional investors and broker-dealers, with a broad range of agency brokerage, clearing and financial outsourcing services. Critical components of the Group's offerings are trade execution, commission management and independent research. Fund managers can maximize the value of their clients' commission dollars by choosing a broker capable of providing best execution and a host of independent third party research services unencumbered by investment banking conflicts. We believe the BNY Securities Group is the largest provider in the U.S. of third-party independent research in connection with commission management arrangements (which we call Independent Research Arrangements). Therefore, we believe we are uniquely qualified to comment on the issues raised by Concept Paper 23-402.

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

Managers first have to educate investors and trustees as to the benefits of independent research. Currently, some advisors have placed arbitrary caps or limits on the use of commissions to obtain independent research as opposed to bundled, proprietary research. The Bank of New York strongly believes that such caps cripple an advisor's ability to take full advantage of the wide array of valuable independent research currently in the marketplace (discussed in more depth in answer to Question 12.). In educating their clients about the value of independent research commissions and removing artificial limits on its consumption, advisors are acting in the best interest of investors.

Furthermore, it is in investors' best interest that both proprietary and third party independent soft dollar commissions be tracked and managed with an adequate degree of transparency and disclosure. This would require that brokers providing both third party and proprietary research report to the advisor with regularity and detail so that advisors can then report and develop a methodology of reporting to their clients. We will elaborate on the topic of disclosure in our response to Question 14.

Question 12 – Are there any additional benefits or concerns that are not noted above?

The Bank of New York strongly believes that any limitation on an advisor's ability to use commissions to obtain independent research will be of detriment to investors. It has been evident for many years, but most pointedly as a result of the bursting of the late 1990's market bubble, that much of the research created by integrated investment banks, and paid for with bundled commissions, may be tainted by conflicts of interest created by association with the corporate finance business. We have observed that advisors increasingly rely on sources of independent research, which is free from such conflicts.

Many independent research firms are small boutiques that do not have their own sales and marketing functions. Such independent boutiques often rely entirely on soft dollar third party brokers as their distribution channel.

In our experience, it is small investment advisors that benefit the most from accessing these independent research sources. Smaller advisors tend to have smaller research departments and greatly benefit from accessing research from a wide array of independent sources. In this way, research commissions allow smaller advisors to compete with their larger competitors. To inhibit an advisor's use of all research commissions would hinder this ability of the small advisor to compete with the larger advisor.

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?

It is the Bank of New York’s view that advisors should decide, consistent with their fiduciary duty, what provides assistance in the investment decision making process. Providers such as Reuters, Thomson and Bloomberg offer highly sophisticated products that include data feeds, quotes, news, analysis, analytics and customizable functions. These products permit fund managers to conduct in-depth research of issuers, industries, economic and market factors and trends. Many fund managers use these tools to support momentum and quantitative investment and trading strategies. These products and services are no less “research” merely because there is an explicit price associated with them (nor because they are dynamic, interactive tools rather than more traditional written research reports).

The following is taken from the Bank of New York’s response to FSA Consultation Paper 176 and addresses the topic:

As fiduciaries, fund managers have an obligation to act in the best interest of their clients. In respect of soft commission arrangements, the FSA’s conduct of business rules restrict a fund manager’s use of client commissions to the acquisition of only those “goods and services that will enhance the provisions [sic] of the [fund manager]’s investment services to its clients.” In the U.S., the Securities and Exchange Commission has stated with respect to soft dollars that “the controlling principle to be used to determine whether something is research is whether it provides lawful and appropriate assistance to the money manager in the performance of his investment decision making responsibilities.” What constitutes lawful and appropriate assistance depends on the facts and circumstances and is “not susceptible to hard and fast rules” or “laundry lists” of specified items. This is because the definition of “research” necessarily will evolve along with changes in market practices, investment strategies and technology. It is up to the fund manager to determine in good faith whether a particular product or service is “research” based on the beneficial effect it has on the fund manager’s investment decision-making process. A policy that would exclude goods and services that otherwise would fall within an appropriate definition of research simply because the demand for them is “reasonably predictable” seems to us arbitrary and unwarranted. The decision is best left to the discretion of the fund manager, subject to his fiduciary duty to act in the best interest of his clients and the fundamental principle that the research must assist the fund manager in the investment decision-making process.

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?

We feel that investors could benefit from enhanced disclosure regarding research commissions used to obtain both proprietary as well as independent research. We believe enhanced disclosure between brokers and fund managers would enable fund managers to fulfill their fiduciary duties by arming them with information necessary for them to determine whether they are determining adequate value – in brokerage and research services – for their clients' commissions.

The following is taken from the Bank of New York's response to FSA Consultation Paper 176 and addresses the issue:

We believe the current system works well. Nevertheless we feel that investors could benefit from enhanced disclosure regarding soft commission and bundled brokerage practices. We believe enhanced disclosure between brokers and fund managers would enable fund managers to fulfill their fiduciary duties by arming them with information necessary for them to determine whether they are obtaining adequate value – in brokerage and research services – for their clients' commissions. Likewise, fund trustees would benefit from enhanced disclosure of the fund managers' soft commission and bundled brokerage practices. Trustees have a duty to ensure a fund manager is acting in the best interest of the fund. It would seem a fund manager's brokerage practices would be an important piece of information to consider in fulfilling that duty. Lastly, enhanced disclosure to beneficial owners would enable investors to make informed investment decisions.

We believe fund managers should be requires to obtain from each broker a full report periodically – no less than quarterly – concerning the commissions earned by the broker and the types of research and brokerage services provided. We believe this happens today with respect to independent research arrangements, but is not the case with respect to bundled brokerage.

We support the IMA/NAPF Disclosure Code and believe trustees are in the best position to monitor brokerage allocation practices and to protect fund investors' interests. We favor expanding the disclosure of total commissions broken out into the following categories: execution-only, proprietary research commissions, directed and commission recapture arrangements and independent research commissions. Trustees should, as a matter of course as part of their duties as trustees, review this information and explicitly consider a fund manager's brokerage allocation practices when deciding whether to retain a fund manager or renew an existing relationship.

We agree with the FSA that average investors would have difficulty understanding detailed transaction cost disclosures. Nevertheless, we believe that investors can benefit from enhanced disclosure of summary information that would provide them with a clearer picture of their fund manager's brokerage allocation practices. We also believe that merely requiring disclosure of this information would enhance the competitive nature of the market for fund management and institutional brokerage. Accordingly, we support annual disclosure to trustees, along with standardized explanatory material to assist them in interpreting the information. We believe this information should be easily understood by investors and should help them assess their fund manager's use of commissions.

Question 15 – What, if any, are the practical impediments to an advisor:

(a) splitting into their component parts commission payments that compensate for both order execution and "investment decision-making services" as a result of either third party soft dollar arrangements or bundled commissions; or

(b) making a reasonable allocation of the cost of "investment decision making services" to the beneficiaries of those services (for example, allocating across mutual funds)?

(a) The Bank of New York proposes separating and reporting commissions in three separate groups. The first group of commissions would be execution-only commissions. The second group would be proprietary, or bundled, commissions paid to full service investment banks. The third group would be independent research commissions used to pay for third party research.

(b) Because research products used by investment managers benefit all accounts and/or funds managed, allocating research costs to particular beneficiaries is not necessary.

Question 16 – If the split between order execution and "investment decision making services" cannot be measured reliably, should the entire commission be accounted for as an operating expense in the financial statements? If it can be measured reliably, should the "investment decision-making services" portion of commission payments be accounted for as an operating expense in the financial statements?

The Bank of New York strongly believes that trade commissions are the best currency for paying for both trade execution and research services. If execution and/or investment decision-making services were to be paid as a fund expense in Canada, it would disadvantage Canadian managers in relation to those managers in countries where commissions can be leveraged to pay for such items. Were such a mandate to be introduced, Canadian managers might be forced to increase management fees as their bottom line expenses increase.

Trade commissions have been, since the formation of Wall Street and Bay Street, the currency of payment for valuable research ideas. This insures a competitive marketplace where a variety of research, both independent and proprietary, can be easily sourced by Canadian advisors.

Conclusion

Independent research arrangements provide a valuable combination of best execution and independent research. Independent research is vital to the financial markets, because it provides advisors with access to a wide variety of thoughts and investment ideas, and the absence of conflicts will help restore investor confidence in our markets. Although the system currently works well, we believe investors can benefit from enhanced disclosure throughout the broker-fund, manager-trustee-investor framework about how their fund managers use or direct brokerage. Most importantly, any contemplated changes must be applied fairly and with due regard for any unintended consequences.