

May 12, 2005

**Via E-Mail**

British Columbia Securities Commission  
Alberta Securities Commission  
Manitoba Securities Commission  
Ontario Securities Commission  
Autorite des marches financiers

c/o John Stevenson, Secretary  
Ontario Securities Commission  
20 Queen Street West  
19<sup>th</sup> Floor, Box 55  
Toronto, Ontario M5H 3S8  
email: [jstevenson@osc.gov.on.ca](mailto:jstevenson@osc.gov.on.ca)

and

Anne-Marie Beaudoin, Directrice du secretariat  
Autorite des marches financiers  
Tour de la Bourse  
800, square Victoria  
C.P. 246, 22<sup>e</sup> etage  
Montreal, Quebec H4Z 1G3  
email: [consultation-en-cours@lautorite.com](mailto:consultation-en-cours@lautorite.com)

Dear Mr. Stevenson and Ms. Beaudoin:

**Re: Concept Paper 23-402  
Best Execution and Soft Dollar Arrangements**

We are responding to the request for comments on the Canadian Securities Administrator's (the "CSA") Concept Paper 23-402 (the "Concept Paper") on behalf of RBC Asset Management Inc. ("RBC AM"). RBC AM is an indirect, wholly-owned subsidiary of the Royal Bank of Canada and provides a broad range of investment services to investors through mutual funds, pooled funds and separately managed portfolios.

We have divided our comment letter into two sections. The first section outlines general comments on various issues regarding best execution and soft dollars and the second section provides responses to a number of specific questions raised in the Concept Paper.

### ***General Comments Regarding Best Execution and Soft Dollar Arrangements***

#### *Best Execution*

The issues regarding best execution are complex and there is no global consensus as to what constitutes best execution or how it should be measured. We are pleased that the CSA put forward the Concept Paper as it is an important step towards increasing the understanding of the issues surrounding best execution, and determining what, if any, regulatory initiatives are warranted.

It is not clear that regulatory intervention is required to ensure that market participants meet their obligations with respect to best execution. However, if following the review of the responses to the Concept Paper the CSA determines that changes to the current regulatory framework are necessary, we would urge the CSA to ensure the following. First, as local solutions cause significant problems and additional costs for market participants that operate nationally, any regulatory initiative should be national in scope and application. Second, as regulatory authorities in other jurisdictions such as the Securities and Exchange Commission and the Financial Services Authority have done significant work in this area, Canadian regulators should aim to incorporate the best of global standards while still ensuring that the unique features of the Canadian marketplace are addressed.

#### *Soft Dollars*

RBC AM supports an industry model that provides investment managers with access to high quality investment research and encourages the development of a strong and independent research community. The methods of paying for research are evolving. It is important at this stage of the evolution to ensure a level playing field between providers of “bundled” (proprietary or integrated) research and transaction services and “unbundled” (independent or third-party) research providers who rely on soft dollars to collect for their products.

The use of so-called “soft dollars” to pay for third-party research has generated a great deal of debate and there have been calls by some to discontinue the practice. In the current model, the pairing of an execution facility with a research service (whether proprietary or independent), allows independent research providers to compete with integrated research providers. If independent research providers were not able to collect payment for services through soft dollars in the same way that proprietary research providers do, the appeal of independent research to buyers would be limited. The complete unbundling of research from execution, consequently delivering full transparency of payments for execution and research services may be desirable, but it should not be accomplished at the expense of independent research providers. In order to achieve unbundling without sacrificing independent research providers, integrated dealers must be exposed to the same competitive pressures as third-party research suppliers.

RBC AM has eliminated soft dollar payments other than for research services. Ours is a more restrictive policy than the Soft Dollar Standards recommended by the CFA Institute. Furthermore, RBC AM's use of soft dollars represents a very modest amount of our overall trading commissions and we monitor our trade executions to ensure all commission payments, including soft dollar arrangements, are at competitive levels and satisfy our obligation to seek best execution for all trades. This demonstrates our commitment to ensure that commissions are spent in the best interests of our clients.

Soft dollar commissions for research are, at present, essential to maintaining a level playing field between integrated institutional brokers and the suppliers of independent research. While we will continue to monitor the evolution of the industry's model for research payments, we strongly believe that as long as integrated dealers have access to commissions as payment for their research, so-too should independent research providers.

### ***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?*

All parties involved in a trade have an obligation to seek to achieve best execution. As an advisor, RBC AM is required to select a dealer for each transaction, set out trade instructions and monitor trade execution. Because a transaction can only be properly evaluated in the context of the market conditions at the time of the transaction and the specific instructions given in respect of the trade, best execution can be measured but cannot be entirely proved. As a result, it is not possible to articulate an objective test with which to measure best execution.

What would be helpful to market participants is to have consistent definitions of the elements of best execution, as well as guidance on how to measure and monitor each element. Industry consistent definitions coupled with guidance on monitoring and measuring would allow purchasers of execution services to more effectively compare dealer performance.

As a mutual fund manager and purchaser of execution services, RBC AM clearly understands its role in best execution. Mutual fund investors select a manager based on a variety of factors. This is often referred to as the "unitholder value proposition." Best execution is clearly a part of the unitholder value proposition but it is unclear that additional education in this particular area would add significant value. Instead, unitholders must be able to rely on a manager's obligation to seek to achieve best execution.

*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?*

It is not appropriate to apply prescriptive rules to the obligation to seek best execution as best execution can only be considered in the context of the market conditions at the time

of the transaction and specific instructions given in respect of the trade. What is appropriate is a principles-based approach whereby each market participant has an obligation to seek to achieve best execution coupled with the requirement to monitor trading and demonstrate execution quality. It is essential that market participants have procedures regarding best execution and the ability to demonstrate that they are monitoring best execution – how each participant fulfills their obligation should be left up to the individual.

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

No comment.

*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?*

RBC AM has implemented an electronic trade order management system that provides us with much of the information necessary to efficiently measure execution quality. It is essential that there be an audit trail that is in an easily-accessible format (electronic or otherwise) that can track different time/date points including the time the trade was received by the trading desk, the time the trade was sent to the dealer and the time the trade was executed.

*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?*

Because a transaction can only be properly evaluated in the context of market conditions at the time of the transaction and the specific instructions given in respect of the trade, best execution can be measured but cannot be proven. Therefore, a description of best execution that focuses on process, not result, is appropriate.

*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?*

As stated in the Concept Paper, it is critical to the analysis of best execution that a market participant be able to measure the execution quality of a trade. In the derivative and debt markets, commissions are embedded into the price of the securities. This lack of transparency combined with limited comparative information (because of few market participants) can make it difficult to measure best execution.

*Question 7:*

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

The same procedures for monitoring and the same standards of measurement should apply to trades executed through the facilities of foreign brokers.

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

The internalization of trades does not change the obligation of a dealer to seek to achieve best execution. The fact that a trade has been internalized does not mean that best execution is unachievable. As long as the party entering the trade receives sufficient information to measure the quality of the internalized trade, internalization should not be an impediment to obtaining best execution.

A best practices approach to addressing the inherent conflict of interest in client-principal trading is to require proprietary trading desks to be segregated from agency trading desks.

*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)?*

No comment.

*Question 10: How is best execution tracked and demonstrated in a dealer market that does not have pre- or post-trade transparency such as the debt or unlisted equity market?*

Although we would encourage increased transparency, we are confident that a competitive market exists and this ensures a degree of discipline. We measure execution based on the information available.

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

As a fund manager, RBC AM takes steps to ensure that services purchased through the use of soft dollars are beneficial to clients. We do so by measuring the benefits received from research purchased through both soft dollars and normal commissions (using both quantitative and qualitative parameters) and tying the results back to the commission allocation process. It is important to remember that in the absence of unbundling, not using soft dollars limits the efficiency of the commission payment process as commissions encompass costs for both execution and research.

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

We reiterate that we strongly believe that soft dollar payments, used appropriately, facilitate access to third-party research, provide a level playing field for proprietary and independent research providers and therefore, promote market efficiency and unitholder value.

*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?*

In the absence of unbundling, it is essential that it remain acceptable to pay for investment decision-making services using soft dollars. The approach taken with respect to what is included as “investment decision-making services” and “order execution services” in Canada should be consistent with, or surpass, global standards. RBC AM limits such goods and services to execution and research and we have adopted an approach similar to that recommended by the Financial Services Authority in evaluating our soft dollar budget and eligible services.

*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?*

Ultimately, we would like to be able to provide clients with full transparency in respect of fees paid for execution and the costs associated with research, independent of the source. However, we can only estimate these figures currently. As a result, such disclosure today would not be accurate or meaningful.

General disclosure of the use of soft dollars by advisors is appropriate as transparency encourages discipline. There should be no difference as to disclosure requirements for third-party or proprietary soft dollar services. Different requirements (even different disclosure requirements) could lead to an unlevelled playing field and unfairly discriminate against third-party research providers.

*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)?*

Currently we are only able to estimate the breakdown of execution and research costs included in commissions charged by integrated dealers. This is because we are not able

to determine the precise dollar value of proprietary research without obtaining input from the executing brokers.

RBC AM has put in place a system whereby we assign points to each portfolio manager based on the number of funds they manage and the assets under management in those funds. The portfolio manager then allocates those points to the analysts/brokers. To assist each portfolio manager in making their allocations, we provide them with various quantitative measures such as analyst rankings, volume of written research provided by each supplier and frequency of telephone/personal contact. Our goal is to ensure that the most points (and therefore a greater share of RBC AM's trading) will go to the dealers that provide the best service to the funds. The process could be further refined to provide an allocation of costs to specific mutual funds.

*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?*

No. See the response to Question #17 below.

*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"?*

No. The MER should only be based on expenses recognized in the audited financial statements and should exclude commissions.

NI 81-106 introduced the "trading expense ratio" in which the total commissions paid are expressed as a percentage of the average fund assets. This may add some additional information but is of limited value because it only deals with explicit costs (ie. commissions) and does not include other factors necessary to evaluate best execution.

Furthermore, too much emphasis on commissions may create an inappropriate incentive to reduce commissions without necessarily improving overall returns and best execution.

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

RBC AM does not accept directed brokerage arrangements for managed accounts nor does it participate in commission recapture arrangements. It is important to remember that where a client requests a directed brokerage arrangement, the advisor's ability to

achieve best execution is compromised. In such cases, the advisor has a responsibility to educate the client about the consequences of such a decision.

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

No comment.

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

No comment.

We would like to thank the OSC for the opportunity to provide these comments on the Concept Paper. Please feel free to contact Dan Chornous at 416-974-4587 or Frank Lippa at 416-974-0609 or Reena Lalji at 416-955-7826 if you have questions or would like to discuss further any of the matters raised in this letter.

Yours truly,

*“Daniel E. Chornous”*

Daniel E. Chornous  
Chief Investment Officer  
RBC Asset Management Inc.

*“Frank Lippa”*

Frank Lippa  
Chief Financial Officer  
RBC Asset Management Inc.

*“Reena S. Lalji”*

Reena S. Lalji  
Senior Counsel  
RBC Law Group