May 12, 2005

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

c/o John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
Suite 1903, Box 55
Toronto, Ontario M5H 3S8
e-mail: jstevenson@osc.gov.on.ca

Anne-Marie Beaudoin, Directrice du secretariat
Autorité des marchés financiers
Tour de la Bourse
800 square Victoria
C.P. 246, 22 étage
Montréal, Québec
H4Z 1G3
e-mail: consultation-en-cours@lautorite.qc.ca

Dear Sirs and Mesdames:

Re: Request for comments on Concept Paper 23-402 Best Execution and Soft Dollar Arrangements (the "Concept Paper")

We have reviewed the Canadian Securities Administrators" ("CSA") Concept Paper with interest and are pleased to provide our comments. Best execution has indeed been a subject of much debate by regulators, market participants and investors in securities markets around the world as the advance in technology and rise in alternative trading systems have increased the complexity of fulfilling the duty to obtain best execution of a client's order. In addition, the practices of soft dollars and directed brokerage continue to be a concern as they have the potential to impede best execution.

The Concept Paper discusses the issue of best execution as having two distinct perspectives: the broker-dealers' ("sell side") and the advisers' ("buy side"). However, TD Asset Management Inc. ("TDAM") would like to suggest that the CSA recognize that clients such as pension plan sponsors ("Sponsors"), in many instances, firmly direct commission recapture and/or brokerage and therefore their role in best execution should

not be overlooked. In addition, Sponsors are not registrants and the question arises as to how they can be regulated. That is an issue that we did not see addressed in the Concept Paper. That said, we are pleased to provide our additional comments as follows.

TDAM is an asset manager in two different scenarios:

- where TDAM is a portfolio manager, that does not retain sub-advisers and does not use Soft Dollar Arrangements as defined in the Concept Paper; and
- where TDAM acts as a portfolio manager that, with respect to some funds it manages, retains sub-advisers who may utilize Soft Dollar Arrangements as defined in the Concept Paper.

Our comments would be in most instances from the perspective of acting in the first scenario and as such, we have focused on questions, which have the most impact on this situation.

By way of background TDAM is one of Canada's largest asset managers. As of March 31, 2005, TDAM managed approximately CDN$107 billion for mutual funds, pooled funds and segregated accounts and provided investment advisory services to individual customers, pension funds, corporations, endowments, foundations and high net worth individuals. TDAM managed approximately $38 billion in retail mutual fund assets on behalf of more than 1.4 million investors at that date.

In reviewing the Concept Paper and in particular addressing the questions raised, it confirmed our view that there was some uncertainty with regard to a broker-dealer's accountability to meet its fiduciary responsibility and we would like the CSA to specifically clarify this uncertainty. We would also like the CSA to confirm our view that the broker-dealers' accountability does not change regardless of whether we traded with them on an agency or principal basis.

It was also evident to us that transaction processes vary significantly across various types of securities and therefore, in our view, prescriptive rules with regard to best execution may be difficult to apply across the board. As outlined below, TDAM would recommend that the CSA consider developing concepts that are broadly defined and more principles based. That is, there should not be highly detailed rules covering a multiplicity of scenarios, but broad based principles that can be applied to numerous scenarios.

As previously indicated, we have focused our attention specifically to the questions raised in the Concept Paper that mostly affect us where we act as a portfolio manager that does not retain sub-advisers. Accordingly, we have not responded to certain questions.

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 help?*

While, we would not recommend developing stringent rules, we would welcome the creation of principles and processes that would regulate the broker-dealers' and advisers' trading practices. In doing so, the CSA should consider outlining clear principles and processes that constitute best execution, and the practices that impede it.

The CSA should also clearly define the roles and responsibilities of the participants responsible for ensuring best execution.

Adviser obligations – In Section 2 (b) of the Concept Paper it is stated that as part of the process for seeking best execution, advisers often have specific obligations: quote, *"First, advisers must ensure that the strategies that they determine for trade execution for their clients are appropriate in the circumstances. Second, advisers must allocate trades fairly among client accounts".* It was further stated that these requirements also impose an obligation on advisers to monitor trading costs and to ensure that they are minimized without foregoing the necessary services from dealers.

Despite what the Concept Paper states above, we do not see that a specific requirement for advisers to monitor best execution exists. In our view, we see that fulfilling (i) the obligation to act in the best interest of clients and deal with them fairly, honestly and in good faith; and (ii) the specific requirements to have fair allocation policies, indicate such a requirement may exist. We strongly believe that there should be specific rules that would clarify the requirements to meet best execution. In this regard, we are of the view that the Trade Management Guidelines issued by the CFA Institute in November 2002 ("CFA Guidelines") contain an ideal concept defined as a "process, starting with the investment decision". We also believe that these guidelines are sufficiently flexible and can be easily adapted to any firm's unique characteristics and circumstances. They focus on processes, disclosures and documentation and together form a systematic, repeatable and demonstrable approach to seeking best execution in the aggregate. In fact TDAM would strongly recommend that the CSA move to a similar principles based rule.

We might add though, that the CSA should also consider when making principle based rules, that there would be instances where an adviser should not have the accountability to get best execution; specifically, where there is client directed brokerage, i.e. where a client dictates which broker's services the adviser should utilize.

Broker-Dealer obligations – TDAM would like broker-dealers to have the obligation to provide reports on their order routing and execution practices. In the US such a report is currently required under National Association of Securities Dealers Inc. ("NASD") Rule 11A-c1-6. We would like to suggest that the CSA should implement a similar rule in Canada, for all orders including the block trades.

The CSA enquired as to whether clients are aware of their role in best execution. Determining what constitutes best execution is somewhat complicated. It involves the evaluation of qualitative and quantitative factors. In our view, it is unreasonable to expect investors to readily understand how the industry works and as such, properly assess their role in best execution. The regulators should prepare and have available to clients, educational material on what constitutes best execution and how best execution affects performance and outline the roles of all parties involved. Clients also need to understand soft dollars. There should be an address that clients could write to for educational information. Such information should be readily available and easily accessible to all clients. We feel that the regulators should also make clients aware of their responsibility to educate themselves to be able to fully understand their role in achieving best execution.

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 stated in our response to Question #1, TDAM would not recommend that the CSA develop stringent or prescriptive rules to govern the obligation of best execution. But on the other hand, we definitely would not suggest that the methods for meeting the best execution obligation be left to the discretion of registrants as discretion is subjective and could result in inconsistent or even contrary methods. It is our view that principles based rules be accompanied by guidelines and explicit examples of best practices to clarify expectations and the application of the principles.

As a guide, we refer you to the British Columbia Securities Commission, Capital Markets Regulation Division, 2003 Adviser Report Card, December 2003, where the following were identified as best practices in the usage of soft dollar arrangements:

- Establish a compliance committee that has a policy and limits on soft dollar expenditures
- Make this committee responsible for approving soft dollar arrangements and create a standard disclosure document for clients
- CFA Institute has established standards to provide guidance on soft dollar issues; review and adopt CFA Institute's soft dollar standards
- Be prudent and cost conscious when investing on behalf of clients.

The report also outlined issues that might arise from the use of soft dollar arrangements, which can impede best execution:

- Some advisers could fail to provide full and fair disclosure of their use of clients' brokerage
- Some advisers could pay much higher brokerage fees than were necessary and indicate that the firms were not cost-conscious about trading fees
- Advisers could fail to disclose soft dollar practices to clients
- Advisers could fail to create and provide a soft dollar disclosure document to clients or fail to disclose the disclosure document was available on request
- Soft dollars could be directed to related parties
- Soft dollars could be used to pay for non-traditional research services.

We feel that if regulators issued similar examples for best execution, firms would have a good understanding of what is expected.

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

In the current environment, a major consideration of best execution is the use of soft dollar arrangements. That said, TDAM would be very supportive of the CSA considering eliminating these arrangements in the long term.

If the regulators eventually take this decision, TDAM believes that there would be a transition period. We are of the view that 'research' could be explicitly included as an element of best execution given it should be capable of adding value. Research should,

as per the Financial Services Authority Policy Statement - November 2004 ("FSA Statement"):

- Represent original thought – that is, the critical and careful consideration and assessment of new and existing facts – and does not merely repeat or repackage what has been presented before;
- Have intellectual rigor and not merely state what is commonplace or self-evident; and
- Involve analysis or manipulation of data to reach meaningful conclusions.

We would also like to add that, where TDAM acts as a portfolio manager that, with respect to some funds, retains sub-advisers who may utilize soft dollar arrangements as defined in the Concept Paper, such sub-advisers, be permitted to use soft dollars provided they are regulated in a sophisticated market and comply with local rules. This approach has been adopted in OSC Rule 35-502 – s.7.3 – Non Resident Advisers.

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 do not believe that the suggested description emphasizing the process to seek the best net result for a client is appropriate and provides sufficient clarity. TDAM is of the view that there is more benefit in the following definition outlined in the CFA Guidelines, particularly because consistent rules would be beneficial; it has greater focus on the process, and because of its inclusion of the investment decision-making process:

"The Guidelines define Best Execution for Firms as the trading process Firms apply that seeks to maximize the value of a client's portfolio within the client's stated objectives and constraints. This definition recognizes 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."*

To put it another way, best execution and/or the best net result for a client is not only about the lowest transaction price.

6.	*Do you believe that there are 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?*

TDAM does believe that there are other issues generally impacting the quality of execution.

We feel that the control of order flow within the upstairs market in Canada has an impact on the ability to obtain best execution for clients. Changes to the regulatory environment

that would encourage competition in the broker/dealer market would be helpful. As can be seen from the US experience, the advancement of competition (from electronic communication networks/alternative trading systems and algorithmic platforms) has resulted in the lowering of trading commissions and an improvement in best execution.

We, as investment managers, are restricted from executing "cross trades" that involve our prospectus and/or non-prospectus mutual funds, pursuant to Section 118 (2)(b) of the *Ontario Securities Act* ("OSA"). We believe this restriction is not in the best interest of clients. It, in effect, precludes advisers from obtaining best execution for their clients.

This restriction not only prohibits the "internal crossing" of common securities within two of these types of portfolios, but also prohibits us from "crossing" common securities by going out to an independent third party broker and requesting that broker to "cross" the securities in question for, presumably, a lower commission (and often a mere administrative charge) and without incurring any market impact costs. Hence, while the "crossing" of a common security between two portfolios would be of benefit to each portfolio (because both portfolios would achieve their investment objective and at a low or zero commission) these benefits cannot accrue to our clients because of Section 118 (2)(b). We believe this rule inhibits best execution and would welcome the CSA eliminating this rule, subject to some controls. Advisers should be able to "cross" securities as long as they are able to obtain pricing from an independent source (including a price obtained from an affiliated broker-dealer, where such affiliated broker-dealer is the only marker maker).

With specific regard to debt securities, given the Canadian Government's debt reduction program and the resulting excess demand for corporate debt securities, we believe that the blanket restrictions on trading with an affiliate, contained in Section 118(2)(b) of the OSA and Section 4 of National Instrument ("NI") 81-102 impede best execution. Specifically in our scenario, TD Securities Inc. ("TDSI"), like TDAM, is a wholly owned subsidiary of The Toronto-Dominion Bank, but otherwise fully independent of our operations. TDSI, being a dominant player in the Canadian corporate debt market, often is the only underwriter/dealer in certain money market securities. In these circumstances where TDSI is actually the market maker and they support the market in that name, there should be no reason why we, despite our affiliation, cannot trade with them. As a result, we are constrained from purchasing many securities for the portfolios managed by us, thereby forcing us to purchase from independent underwriters/dealers, other securities that may be transacted at prices higher than the securities that we wanted to purchase through TDSI.

While we appreciate the importance of regulating conflicts of interests, we are of the view that any restrictions in this regard should not be so stringent that makes it impractical to transact. We would recommend that the CSA consider revising rules that cause these impediments that in effect preclude us from providing our clients with best execution. TDAM would be happy to work with the CSA in drafting amendments to Section 118(2)(b) and / or NI 81-102.

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

Brokers in Canada should have the same accountabilities with respect to achieving best execution for their clients, even when they utilize a foreign executing broker. As such,

the same way an adviser has an accountability to monitor its broker and how it obtains best execution, so too would we expect the brokers to monitor whether the foreign executing broker is achieving best execution for them. We suggest that a process of periodic evaluation of the execution performance of these foreign brokers would particularly be necessary and should be specified as a regulatory requirement.

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

TDAM supports internal crossing by investment managers as described in 6 above. However, we believe that widespread internalization of orders by broker-dealers has the potential to represent an impediment to obtaining best execution if broker-dealers hold up orders while looking for off-setting internal order flow. Furthermore, given the large size of many broker-dealers in Canada, the number of orders that could potentially bypass the primary market could be significant. As a result, it could fragment the market and diminish the market's ability to act as an efficient price-discovery mechanism.

We believe that there is a need for further study on the impact of internalization by broker-dealers in Canada, before any specific regulations are proposed. In the interim there should be adequate regulatory controls on the broker-dealers, to ensure that these practices are not abused.

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 are not of the view that at this time it is necessary to require that dealers and advisers obtain multiple quotes for OTC securities. This may cause an adverse effect to prices, as multiple quotes may create artificial demand or availability and as such, prices would tend to move against the intended trade.

With regard to a mark-up rule that would prohibit dealers from selling securities at an excessive mark-up from their acquisition cost, we believe that it might be difficult to incorporate such a rule. The mark-up, as a percentage, would need to be high when principal amounts traded are very small. Otherwise, the dealer would not provide liquidity in these circumstances. A reasonable mark-up percentage would be difficult to determine in certain scenarios especially when the broker has held a security in inventory and has not seen recent pricing for it.

In any event, we do not believe that the rule would be needed on the institutional side, though it may be needed on the retail side.

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?*

It is our view that best execution could be tracked and demonstrated in a dealer market that does not have pre or post-trade transparency such as the debt or unlisted equity market, by obtaining the required information through sources that are available to us. For example, for debt securities, TDAM can use the previous trading night's spreads, third party automated trading platforms and any available information from index

providers as proxies for pricing for individual debt issues and guidance on the direction we think the market is trading.

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?*

As previously indicated, TDAM theoretically believes that soft dollar arrangements should ultimately be abolished. However, pending a transition period, in the interim, we are of the view that soft dollars that assist in the construction of the portfolio or have an intellectual or analytical component to them should still be maintained. In other words we would recommend that the definition of such services be clarified in the manner outlined in the FSA Statement identifying, in particular, the types of services that are allowed and those, which are not allowed.

The FSA Statement states that commission should be limited to the purchase of 'research' and 'execution'.

- 'Research' should be capable of adding value by providing new insights that inform fund managers when making investment or trading decisions about their clients' portfolios. Further details of the FSA definition is included in our response to Question #3

'Execution' services should meet two specific criteria:

- They must be demonstrably linked to the arranging and conclusion of a specific transaction (or series of related transactions); and
- They should arise between the point at which the fund manager makes an investment decision and the point at which the transaction is concluded.

It further outlined services that were not sufficiently connected with particular investment decisions or transactions to be classified as 'research' or 'execution' and as such were categorized as non-permitted services, such as:

- Services relating to the valuation or performance measurement of portfolios;
- Computer hardware;
- Dedicated telephone lines;
- Seminar fees;
- Subscriptions for publications;
- Travel, accommodation or entertainment costs;
- Office administrative computer software, for example, word processing or accounting programs;
- Membership fees to professional associations;
- Purchase or rental of standard office equipment or ancillary facilities;
- Employees' compensation; and
- Direct money payments.

Additionally, it is our view that consultant fees should be a non-permitted service and we might add that the cost of Bloomberg machines should also technically fall into the

category of the 'non-permitted services' as it does not meet the qualities of the services that fall under 'research'.

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

The disclosure requirements for soft dollars specified in OSC Policy 1.9 and AMF Policy Statement Q.20, NI 81-101 and NI 81-106, do not appear to be adequate. We would recommend that there should be more disclosure in order to address issues of transparency surrounding the use of soft dollars. The CSA should ensure, however, that the information that is disclosed, and the location of that disclosure, is helpful and useful to investors and accurately meets the objective and purpose of the disclosure. In addition, it would be advisable to ensure that appropriate information is provided, in an effort to avoid any further confusion and misinformation about soft dollars.

<u>For Prospectused Funds</u>

Currently the following will be required to be disclosed in the Financial Statements (as per amended NI 81-106):

- Total commissions paid (Section 3.6(3)(a))
- Total commissions paid to related parties (as per GAAP)
- Total research portion of commissions paid, to the extent the amount is ascertainable (Section 3.6(3)(b))

Currently the following will be required to be disclosed in the Annual and Interim Management Reports of Fund Performance ("MRFP") (as per amended NI 81-106F1):

- Portfolio turnover rate (indication of how actively the Fund's portfolio adviser manages its portfolio investments) (Part B Section 3.1)
- Trading expense ratio (represents total commissions and other portfolio transactions costs expressed as an annualized percentage of daily average net assets during the period) (Part B Section 3.1)

We would like to suggest that the 'brokerage arrangements' disclosure in the Annual Information Form ("AIF") (NI 81-101F2 Section 10.4) be expanded. We feel that the expanded disclosure should include:

- A brief narrative description of the various types of trading costs incurred by the fund, including commissions, markups and markdowns, market impact costs, and opportunity costs.
- The manner in which the fund will select brokers to effect securities transactions.
- The manner in which the fund will evaluate the overall reasonableness of the brokerage commissions paid, including the factors that the fund will consider in making these determinations.

<u>For Non-Prospectused Funds</u>

TDAM would recommend that the CSA consider including in the financial disclosure for these types of funds, disclosure similar to what is provided in respect of retail funds (whether it's included in the financial statements, the MRFP or offering documents).

Other Clients

TDAM would recommend that the CSA consider implementation of a disclosure document that would provide similar type of information for each client.

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)?

TDAM notes that the main impediment to an adviser splitting the execution costs is primarily that the breakdown of these execution costs are not readily available from brokers.

(a) We are of the view that the ability to unbundle commissions is completely dependent on the brokers or the 'sell side' and that as an adviser or the 'buy side', we certainly cannot unbundle with any kind of precision at this time, with the lack of the required information. If the CSA wants information that is comparable among the buy side firms, then we believe that the CSA should require the 'sell side' to disaggregate the commission costs and provide information to the 'buy side' firms.

b) We do not believe that we could make a reasonable allocation of cost of 'investment decision-making services' to the beneficiaries of those services without the information from part a). It should be possible to allocate cost, based on similar mandates as long as the information from part a) was made available.

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 the commission payments be accounted for as an operating expense in the financial statements?*
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".*

Including brokerage commissions, in any aspect, into an MER will ultimately be confusing and do more harm than good. It will encourage fund managers to exert pressure on portfolio managers to keep trading low in efforts to keep MERs low. This may not always be in the best interest of a fund or its unitholders. Fund economics and portfolio management should be kept separate and one should not influence the other. Brokerage commissions have a direct impact on performance, which is where unitholder

focus should be. Including this into an MER could also have the effect of obscuring the true operating expenses of the fund. Under NI 81-106 a new Trading Expense Ratio (TER) will be included in the Management Report on Fund Performance. This way unitholders can see the MER and TER separately while still getting a feel for the overall valuation impact.

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

If the CSA continues to permit client directed brokerage and commission recapture, then the CSA should grant the adviser an exemption from its fiduciary duty to obtain best execution, for those trades. In addition, there should be a specific rule that commission recapture is for the direct benefit of the client i.e. the underlying mutual fund (not the mutual fund manager) or the pension plan members (active or retired) (not the pension plan administrator).

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

As a portfolio manager, TDAM does not need any specific mandatory disclosure requirement. If the CSA leaves client directed brokerage and commission recapture arrangements in place, TDAM would suggest that clients should have the ability to ask for additional information on directed brokerage and recapture arrangements, which the adviser should then be required to provide. This would be in line with the CFA Institute's Soft Dollar standards.

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

As already indicated, TDAM supports many of the initiatives from other countries. Specifically the following:

- The NASD rules 11Ac1-5 and 11Ac1-6 – Disclosure of Order Execution and Routing Practices
- The FSA Consultation Paper 05/05 Bundled Brokerage and Soft Commission Arrangements - proposed definition of 'research' including outer-perimeter as a reference to non-permitted services
- The NASD Mutual Fund Task Force – proposed disclosure

In the short term, we would also like Canadian regulations to clarify, as it was done in the US in section 28 (e) of the Securities and Exchange Act of 1934, that money managers might consider the provision of research, as well as execution services, in evaluating the cost of brokerage services without violating their fiduciary duty.

In conclusion, TDAM commends the CSA for taking the initiative to address the concept of best execution and soft dollars in the Canadian investment industry. We agree that there should be clarity in the definition and understanding of which issues affect best execution and the allowable expenses for which soft dollars may be used. We also agree that the CSA should ensure that there is an appropriate regulatory framework in place, but would like to reiterate that such regulation should be in the form of concepts that are broadly defined and principles based. Finally, we would like the CSA to consider the Sponsors' role in best execution and how it should be addressed.

We would be happy to provide any further explanations or submissions regarding the matters discussed above and would also be willing to make ourselves available for a further dialogue.

Yours truly,

Barbara Palk
President
TD Asset Management Inc.