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May 12, 2005

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RE: COMMENT LETTER ON CONCEPT PAPER 23-402 (the "Concept Paper"): BEST EXECUTION AND SOFT DOLLAR ARRANGEMENTS

Please find enclosed a combined response to the Concept Paper submitted from Mackenzie Financial Corporation and Investors Group Inc. We appreciate the opportunity to provide comments on the Concept Paper.

INVESTORS GROUP INC.

Per: W. Terrence Wright, Q.C.
Senior Vice-President,
General Counsel and
Secretary

MACKENZIE FINANCIAL CORPORATION

W. Sian Burgess

Per: W. Sian Burgess
Senior Vice-President and
General Counsel

Enclosures

I. Best Execution

Introduction

Best execution, while seemingly a straightforward concept is difficult to apply in practical terms. Historically, the focus has been on quantitative measurements to assess best execution. However, statistical measurements can be only one part of the overall assessment that firms may use in examining best execution. Best execution is not simply the lowest commission paid or even the lowest price paid for the security. The Concept Paper accurately states that best execution is the result of a process and not a single absolute value that is obtained on a trade-by-trade basis.

Although the Concept Paper alludes to it, the CFA Institute has also defined best execution. Within their definition, the CFA Institute clearly demonstrates the complexity that is inherent in assessing best execution. They define best execution as "the trading process firms apply that seeks to maximize the value of the client's portfolio within the client's stated objectives and constraints. The 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."

The Canadian Securities Administrators ("CSA") should also recognize that fund performance is a key consideration for advisers in a competitive market place. Achieving best execution will ultimately support a fund's performance and therefore the adviser is incented to work to achieve best execution.

We would urge the CSA to work with other jurisdictions as part of its analysis of best execution and consideration of any regulatory requirements. Given the global nature of the financial services industry it is critical to the ongoing efficiency and competitiveness of the industry to have consistent regulations with major international markets. In addition, any proposal for regulatory change should be harmonized across other investment products such as segregated funds and pooled funds. We would suggest that it would be beneficial for the members of the Joint Forum of Financial Market Regulators to discuss this issue as part of their efforts to coordinate and harmonize regulation of financial products and services in Canada.

We have provided our responses to the questions posed in the Concept Paper with respect to best execution:

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?

Comment

Responsibilities should be more clearly outlined as to who is accountable for best execution versus the responsibility for the best price. The Concept Paper comments that it is "universally acknowledged that a dealer handling the order for a client has an obligation to seek best execution when executing that order"'. The obligations of the dealers as stated within National Instrument 23-101 and the Universal Market Integrity Rules, is to obtain the best execution price, which is only a component of the broad definition of best execution. As noted within the paper itself and in our comments, best execution is a process that considers a number of elements including the objectives of the client and that contemplates or goes beyond best price alone. Advisers are responsible for ensuring best execution with respect to each order given that they have all information relating to the client objectives, actual size of the order from the client and other pertinent information required in process of assessing best execution. Dealers do not have these details and as such regulations for dealers should appropriately reflect the different scope of the dealer's obligations.

We are of the view that any form of education aimed at assisting clients in increasing their knowledge and awareness of the financial markets and its impacts on investments they may hold, is beneficial. Many of the concerns that may be expressed by clients are in fact due to a lack of awareness of their obligations in communicating orders to dealers.

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?

Comment

A principles based approach to regulation would clearly be the appropriate manner to regulate this area. As stated within the Concept Paper itself, best execution "is the outcome of a process and not an absolute value determined on a trade-by-trade basis". The application of a set of prescriptive rules would fail to recognize this process. Rather, allowing registrants to make a good faith determination on whether they obtain best execution would be a more applicable and relevant approach. We would argue that applying a more prescriptive approach to regulating best execution may in fact result in there being difficulties in achieving this outcome.

A prescriptive approach may not contemplate that execution costs contain a number of components including commissions, market impact and costs of delay (the cost of waiting to complete the trade caused by changes in market price before the trade is completed plus the opportunity cost of not using the available cash that is allocated to the pending trade).

Prescriptive rules may result in a focus only on quantitative elements that are easier to measure and assess yet may not contemplate the variability of factors that affect each trade, and may not address those elements which are qualitative or subjective but which as noted above contribute to best execution.

Question 3

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

Comment

The elements listed within the Concept Paper accurately reflect the key elements of best execution and are generally those which could be measured in a substantive, though not complete or consistent manner. Each of these elements is variable in weight, importance or influence in relation to each specific trade and may in fact be irrelevant depending on the particular trade and the intent of the client. Therefore any definition or description of best execution must be general in context and considers the process of evaluating the elements that are described and the objectives of the client for that particular trade.

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?

Comment

The existence of an audit trail that is easily accessible, while important in evaluating certain elements of best execution, would not capture all aspects needed to assess the process of achieving best execution. An absolute value on a trade-by-trade basis could be determined if information is obtained in electronic form. However this data should not be considered in isolation, as it may not result in an accurate conclusion on whether best execution is being achieved.

While third party execution valuation services can provide tools that may be helpful to evaluate execution, advisers must be aware of the limits of these services. Finding a benchmark that provides meaningful information is complicated and will require time to assess the usefulness and limitations.

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?

Comment

The suggested description in the Concept Paper does not fully reflect that the evaluation of best execution is a process and not a single event. While the description does incorporate the key elements of best execution and reflects that these elements need to be evaluated against the objectives of the client, it is not clear that this evaluation should be completed over a period of time. It may be inferred that best execution is a process but the description should more clearly articulate this fact. The description should therefore be modified to read "best execution means the process of evaluating whether the client achieved the best net result, considering the relevant transactional elements at that particular time (including price, speed of execution, certainty of execution, and total transaction costs) and the client's stated investment objectives."

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?

Comment

Listed Equities

We believe that there are a number of issues that may affect the quality of execution for listed equities within the Canadian market. As part of the CSA's analysis we would suggest that differences between the Canadian and US market be incorporated into the assessment. Issues that we would highlight with respect to listed equities include:

- Transparency: Most of the institutional trading in Canada flows through the "upstairs" market where the negotiation of price is not reflected in the electronic retail trading activity that is viewed during the day. The TSX has become the exchange where board lots are transacted and the upstairs market has become the exchange for large blocks.

- Liquidity: In the Canadian market, institutional investors hold large security positions. International competitive pressures have resulted in mergers of mutual fund managers which have resulted in consolidation of security holdings. Additionally, in Canada there are fewer provinces as compared to the number of states in the US, which has resulted in the provincial pension funds holding significant security positions relative to the size of the market. As a result of this concentration of security positions, Canada appears to have evolved into a "two-tier" market of large and small players, with no middleman. Meanwhile, in the US there seems to be a broader spectrum of buy-side clients of all sizes that enhances liquidity. The market for large blocks is less liquid by definition and as a result, in Canada, the market relies heavily on bank investment dealer capital.

Unlisted Equity Securities

Unlisted equity securities present transparency and liquidity issues because they are traded over the counter and there are limited dealers who trade these securities.

Derivatives

Derivatives, whether exchange traded or traded over-the-counter, present liquidity issues because there is a limited number of dealers, typically the bank investment dealers, who will trade in these instruments. Additionally, derivatives that are traded over-the-counter may present transparency issues because there is no formal trade reporting system.

Debt Securities

With respect to debt securities the most significant issue is transparency. There is no trading information widely available and so portfolio managers must shop around to find the best price. The challenge with the bond market is that there is no mechanism in place to know what is being traded on a day-to-day basis. While there are records of quotes during the day there is no record of the trades that were executed. Additionally, liquidity issues exist for high yield debt securities because not all dealers will trade in all the issues.

A few large dealers provide quote details on Bloomberg for Government of Canada bonds, provincial bonds and some corporate bonds. However, these quotes tend to be indicators of prices and cannot be relied upon as traded prices.

The adviser must contact the dealer directly to get a firm price. While some electronic systems have been developed they tend to assist with trading in the more liquid and transparent bonds. In Canada the Candeal electronic trading system, can be used for Government of Canada bonds, some provincial bonds and government agency bonds. This trading system provides the most accurate information for government bonds. However, it should be noted that the government bond market generally tends to be more liquid and transparent. In the US, the TRACE electronic trading system is used for corporate bonds. This system provides trading information such as where the bonds traded, the amount and the price of the trades. However, the trading activity on TRACE reflects both retail and institutional trades and therefore results in a fair amount of price variability.

Based on the transparency issues noted above an assessment of the elements of best execution for debt securities is effectively restricted to the limited price discovery process.

Question 7

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

Comment

This question would be relevant to dealers and therefore we have not provided comments.

Question 8

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

Comment

Internalization may act as an impediment to obtaining best execution to the extent that this trading activity restricts the number of shares that are available for trading on the exchange.

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)?

Comment

We again affirm that rather than establishing prescriptive rules that a principles based approach be adopted. This would require the adviser to establish certain policies and procedures to demonstrate the process of achieving best execution. We believe it is the obligation of the adviser to make a good faith determination on whether they obtain best execution to be in a position to demonstrate that good faith determination.

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?

Comment

An adviser would demonstrate best execution in the same manner as in dealings in certain markets that may have more transparency. The process to evaluate best execution that is utilized by the adviser should take into account all security types and markets where a transaction may occur.

II. Soft Dollar Arranaements

Introduction

The Concept Paper has raised a number of questions with respect to whether the practice of using soft dollar arrangements poses a barrier to best execution. While the usage of soft dollars may present certain potential conflicts of interest that can be addressed through appropriate usage of services and disclosure, these issues should not have an affect on the ability to achieve best execution.

The Concept Paper makes certain references to the concept of a "mark-up" on commissions that are used to pay for soft dollars. We would point out that, in our experience, there is no difference or "mark-up" in the commission rate that dealers charge for trades that are used for soft dollar arrangements versus regular trades. Dealers use the same commission schedule regardless of whether or not the trade is to be used for soft dollar services. Where trades are used for soft dollar arrangements the dealer retains a portion of the commission with the remainder being paid to the vendors providing the services that are paid through the soft dollar arrangement.

Another criticism of soft dollar arrangements as documented in the Concept Paper asserts "it is also difficult to measure whether best execution is obtained in the case of soft dollars as trading commissions at the base of the arrangement sometimes include services for dealers that are bundled and sometimes are for execution only". As noted above, the commission rate that is paid on soft dollar trades is no different from regular trades. Therefore, the ability to split out the services that are included within the commission cost is an issue for all trades not just trades that may be used for soft dollar arrangements. It should be emphasized that best execution cannot be assessed purely based on one number such as the commission rate. Although commission costs are easy to understand they are not the primary driver of best execution. There are a number of factors that go into the evaluation of best execution including price, liquidity, timeliness, market impact etc. The quality of execution, the speed of execution, market intelligence, and service all combine to achieve better execution for a fund.

The Concept Paper has noted "critics of soft dollars contend that dealers do not work as diligently on an order when they know the trade is a soft dollar trade, since they are being paid a fraction of their usual commission." We would agree that while the dealer retains a fraction of the commission where commissions are identified to be used for soft dollar expenses our experience is that this factor does not affect their diligence with respect to working our orders. Traders and portfolio managers have an overriding consideration with each trade to achieve best execution and therefore if a dealer were not fulfilling this requirement then the consequence would be loss of business.

For certain dealers, the ability to soft dollar a portion of the commission dollars is their primary line of business. Certainly for these dealers, if they cannot compete on order fills then they will not be able to sustain their business model. For other dealers where this is not their primary line of business, in many cases they do not know if a trade is to be soft dollared until the trade is ticketed. However, whether the dealer is aware that the trade is to be soft dollared will not be a factor in the level of diligence used to execute the trade because the buy-side trader will evaluate each dealer on their ability to achieve order execution and if a dealer is not diligent in their efforts then the trader will discontinue using them.

We have provided our responses to the questions posed in the Concept Paper with respect to soft dollar arrangements:

Question 11

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

Comment

Advisers are obligated to act in the best interest of fund investors. They must use their best efforts to obtain best execution for all trades initiated for their managed accounts, including soft dollar transactions. Each adviser is required to develop policies and procedures to ensure that trading practices are consistent with meeting their obligation to fund investors which would include such policies as trading and supervision, best execution and trade allocation. It should be pointed out that an adviser's trading policies would apply to all trades irrespective of whether they were to be soft dollared. Policies and procedures for soft dollar arrangements are developed to define the permitted expenses that may be paid through soft dollar commissions as well as describing the monitoring, reporting and control processes to address potential conflict of interest issues. Additional measures to be addressed would include appropriate approval processes for new soft dollar arrangements as well as establishing an independent monitoring of soft dollar usage by the compliance function.

Question 12

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

Comment

As noted in our response to Question 11, advisers are obligated to act in the best interest of fund investors. We would suggest that the issue of soft dollar arrangements be looked at carefully and in consultation with all those affected, including brokers, investment managers, as well as other regulators including the

Financial Services Authority ("FSA") and the Securities and Exchange Commission ("SEC"). Any requirement by the regulator to eliminate the usage of soft dollars without the unbundling of commission costs may result in the undesired situation where certain benefits that are available to fund investors would be foregone. It would seem that this concern has been considered by the FSA and the SEC such that their focus appears to have shifted from the elimination of soft dollar arrangements to providing a clearer definition of the nature of expenses that would be considered 'research' as part of the investment decision-making process.

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?

Comment

We are supportive of the approach taken by the FSA and the NASD Mutual Fund Task Force where they have proposed to limit the use of soft dollar services to execution and research and are working to provide high level guidance on the characteristics of 'research' services for permitted services while providing detailed listings of those services that would not be permitted. Additionally, they have not differentiated between bundled and third party research which is viewed positively and will aid in encouraging the development of independent research and analysis to the benefit of investors.

The FSA has been in discussions with the SEC to coordinate efforts on rules impacting international asset managers. With the increasing globalization of the asset management industry, coordination with other regulatory entities is valuable to facilitating compliance with the rules. We would encourage the CSA to engage in discussion with the FSA and SEC as part of any assessment 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?

Comment

We are supportive of disclosure requirements that enhance investors' understanding of a fund's practice when addressing potential conflicts concerning the payment methods for investment research. However, we would take this opportunity to raise a concern with respect to the requirement under NI 81-106, Part 3.6 (3) (b) that states that the notes to the financial statements of an investment fund must disclose ... *"to the extent the amount is ascertainable, separate disclosure* of *the* soft *dollar portion* of *these payments, where the* soft *dollar portion is the amount paid or payable for goods and services other than order execution".* This disclosure contemplates only third party soft dollar arrangements and does not include proprietary research. This approach to disclosure may be considered somewhat biased because it does not accurately represent the full cost of research that may be paid through soft dollars arrangements. This bias could potentially permit confusing or misleading disclosure by an adviser who states that they do not use soft dollars because they are not paying for third party services. However, their fund investors may actually be receiving the benefit of certain soft dollar arrangements through proprietary research services that are paid for through bundled commission costs. Secondly, without an accurate accounting of the breakdown of execution and research costs that are included in the commission structure any disclosure of the cost of proprietary research will be based on estimates and will vary between advisers. As a result, disclosure may not be meaningful to investors due to inconsistent treatment of soft dollar arrangements.

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)?

Comment

(a) Commission payments that are used to pay for third party soft dollar arrangements can be verified through the invoicing provided by the service providers. An assessment of the portion of bundled commission payments, exclusive of third party services, that would be split between "execution and investment decision making services" would be difficult as the split would depend on a number of factors including the nature of the security and the particulars of the trade (Le.liquidity) as well as factors such as whether the commission includes proprietary research services. On a trade-by-trade basis, these factors may have different "weights" within the commission that was paid. It would be difficult to achieve a measure of consistency without a breakdown of the commission costs by the dealer.

(b) Attempting to make a reasonable allocation of the cost of "investment decision making services" to the beneficiaries presents a number of challenges in a large fund complex. Typically a portfolio manager advises on a number of funds and therefore, while certain funds may generate commission dollars that contribute to available soft dollars that are used to purchase research services, other funds may benefit from this research where there is common management. This does not detract from the benefit derived by the fund which generated the commission used for the soft dollar expenditure. The CFA Institute published Soft Dollar Standards in 1998 which recognized that "while it is permissible for the adviser to use a client's brokerage derived from trades to obtain research that may not directly benefit that particular fund at that particular time, the adviser should endeavor to ensure that, over a reasonable period of time, the client receives the benefit of research purchased with other fund's brokerage." The Soft Dollar Standards require that an adviser must disclose whether it may use research to benefit clients other than those whose trades generated the brokerage.

Based on the challenges of trying to match the costs of "investment decision-making services" to the benefits may not be reasonable to assess given the pooled nature of investment management structures. Requiring an allocation may result in an arbitrary calculation and may not add real value for fund investors. We would suggest that this issue needs further study.

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?

Comment

The accounting treatment of the commission costs should only be assessed when accurate reporting is available with respect to the split between the order execution and "investment decision making" services. Without a reliable breakdown, as noted previously, the value of disclosure and information is compromised because of the concern of inconsistent estimates and treatment. While the net performance data of a fund would not be impacted by this proposed reallocation, the gross performance data for a fund would be impacted. Any proposed accounting treatment changes should be studied carefully to ensure that the implications are fully understood.

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"?

Comment

Any changes to the accounting treatment of expenses should be carefully studied to understand the impact. We believe that it would not be appropriate for the MER to be based on amounts that differ from the expenses recognized in the audited financial statements. Differing amounts may lead to investor confusion with respect to the comparability between different fund complexes, as well as with historical MER calculations. We would recommend that reporting of the MER be consistent among the various disclosure documents to provide value to fund investors and to minimize confusion that may arise when disclosing different amounts.

Question 18

Should directed brokerage or commission recapture arrangements be limited or prohibited?

Comment

We do not engage in directed brokerage or commission recapture arrangements and therefore do have any comments to provide.

Question 19

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

Comment

See response to Question 18.

Question 20

Would any of these initiatives be helpful in Canada?

Comment

We would comment on the desire to ensure that any modifications or additions to regulations in Canada with respect to best execution and soft dollars should carefully consider what has been contemplated in other jurisdictions. The global nature of the investment management industry requires that any changes to best execution or soft dollar arrangements should be consistent in order to minimize impediments to competition as a result of regulation.

In addition, we would suggest that the CSA consider the efforts that are being made currently in the United Kingdom on the issue of unbundling of commissions. In reviewing what has been communicated by the regulatory authorities in the United States ("US") and the United Kingdom ("UK"), there seems to be differing approaches to this issue. The United Kingdom is attempting to move forward with significant change and require unbundling of commissions whereas the NASD has made recommendations on the basis that there will be no change to the current commission structure. Whether the SEC is going to address the issue of commission bundling is yet to be seen. We have noted that this Concept Paper is silent on this topic and we believe that this is an important issue that should be considered.