



## ACCOUNTABILITY RESEARCH CORPORATION

121 King Street West, Suite 2200, Box 101  
Toronto, Ontario M5H 3T9  
tel. 416-367-3352 • fax 416-363-4849

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Ontario Securities Commission  
SECRETARY'S OFFICE

October 18, 2006

British Columbia Securities Commission  
Alberta Securities Commission  
Saskatchewan Securities Commission  
Manitoba Securities Commission  
Ontario Securities Commission  
New Brunswick Securities Commission  
Securities Office, Prince Edward Island  
Nova Scotia Securities Commission  
Securities Commission of Newfoundland and Labrador  
Registrar of Securities, Northwest Territories  
Registrar of Securities, Nunavut  
Registrar of Securities, Yukon Territory

c/o Mr. John Stevenson, Secretary  
Ontario Securities Commission  
20 Queen Street West  
Suite 1903, Box 55  
Toronto, Ontario M5H 3S8

and/et

Madame Anne-Marie Beaudoin  
Directrice des secrétariats  
Autorité des marchés financiers  
800, square Victoria, 22e étage  
CP 246, Tour de la Bourse  
Montreal, Quebec H4Z 1G3

**RE : REQUEST FOR COMMENT ON PROPOSED NATIONAL INSTRUMENT 23-102**

We are pleased to provide comment on the proposed National Instrument 23-102 and its Companion Policy regarding the Use Of Client Brokerage Commissions As Payment For Order Execution Services Or Research ("Soft Dollar" Arrangements). Accountability Research Corporation is an organization dedicated to the independent investment research of North American companies. Our clients comprise the investment management divisions of pension plan sponsors, institutional investment managers, and investment counsel portfolio managers (ICPM) focused on individual client account management.

## ***General Comments***

We believe that most of Canada's investment managers (advisers) act in an ethical manner when it comes to the expenditures of their clients' commission funds through the use of soft dollars. As an independent research provider to buy-side organizations and advisers we are a recipient of soft dollars from a number of our clients.

In regards to our total revenues and soft dollars, we estimate that approximately half of our clients use soft dollars to pay for our services. Those clients that do not use soft dollars are primarily smaller ICPMs (for whom soft dollars are not readily available) and publicly accountable pension plan sponsors. However, there is no general pattern as to the type of firm that pays with soft or hard dollars for our research services.

Our smaller ICPM clients have no choice but to use hard dollars to pay for our services because the Canadian market has not developed a competitive custodian and trustee system, resulting in a "quasi" monopoly as ICPM firms can only use the services of one custodian or trustee. This service provider is affiliated with a retail discount broker/dealer and thus an ICPM generally executes the majority of their clients' trades at retail brokerage commission costs. Despite the fact that these trading commissions are higher than institutional soft dollar costs, this service provider does not allow these advisers to build soft dollar budgets. Without the access to soft dollars, these advisers have little room in their operating budgets for the type of third party research or order execution services available to institutional advisers.

We have found that Canadian advisers are economical in their use of soft dollars and are reluctant to increase their soft dollar budgets beyond the costs of their current service providers. This makes the entrance of new research services difficult to receive ongoing support and funding through the use of soft dollars when compared to existing funded mixed-use services such as Bloomberg, Reuters or Thomson and broker/dealer bundled research.

In general, we favour any policies whereby advisers are able to use a variety of payment methods for components in their investment research process, provided that these services have a reasonable impact on their investment decisions (which in turn benefit their clients). However, we take exception to certain issues within the proposed policy that would limit a number of advisers from purchasing "qualified" investment research services such as ours because of a crowding out of their soft dollar budget.

Lastly, we believe that commissions ultimately belong to the clients that pay for them. Accordingly, advisers must provide mandatory firm-wide disclosure with regards to their soft dollar expenditures. In doing so, advisers will ensure that clients receive transparent disclosure as to salient details relating to their commission dollar expenditures.

## ***Specific Comments to Questions Posed by the Request for Comment***

For the sake of brevity we will only answer those questions for which we can provide significant insight.

### **Question 1: Independent Pricing Mechanism and Principal Transactions**

We understand that that the North American fixed-income market is four times the size of the corresponding equity market and most initial or secondary public offerings of securities are brought to market using principal transactions. Thus there are a significant number of advisers

who buy and sell securities in the fixed-income or equity principal market. Additionally, we understand that a significant number of these managers have been able to negotiate soft dollar arrangements with their various broker/dealers for these principal trades.

If principal transactions are excluded from the proposed instrument, then unscrupulous managers with both fixed income and equity mandates will shift non-eligible expenses defined by the instrument from equity soft dollars towards those soft dollars related to principal transactions. Thus, by excluding principal transactions, this proposed instrument will not remove potential unscrupulous behaviour on the part of advisers, but will rather allow this behaviour to continue under an even greater opaqueness of the principal market.

We understand that soft dollar arrangements made by fixed income and balanced advisers, as well as the creation of the broker/dealer controlled fixed income exchange (CanDeal), have created greater transparency into the cost of soft dollar and execution costs in these principal transactions. We urge the commission to pursue the inclusion of fixed income and principal transactions as part of this instrument and companion policy.

#### Question 2: Reasonability of commissions paid in relation to value of goods and services

If research purchased through the use of soft dollars assists an investment manager in making an investment decision, then we consider this expense a prudent use of soft dollars. However, in many instances, research or the by-products of research inputs result in investment managers/advisers choosing not to execute a specific transaction. By not executing a transaction, soft dollars are not generated for the client's use to pay for the research that resulted in the investment decision. Therefore, we believe that research services should be broadly defined to include those inputs into the investment process used by advisers on behalf of clients.

Moreover, it is difficult for advisers to determine the value of investment decisions which result in a non-execution outcome or are part of the mosaic of information in the research process. Thus, any reasonability test for the "qualified" goods and services eligible for soft dollars should be broad in scope and provide the adviser significant discretion. Substantial and meaningful vendor-by-vendor disclosure of soft dollar expenditures provided to clients will balance any potential improper use of soft dollars by advisers.

A number of clients have arranged direct brokerage agreements with specific broker dealers that the adviser must then utilize. These trades will result in commissions which may have a soft dollar component and to which the broker dealer or client restrict the soft dollar usage. The result of these directed soft dollar commissions is that an adviser may purchase services that, under normal circumstances, would not have been purchased. The reasonability of these soft dollar expenditures is questionable even though they are at the specific intentions of a client. Moreover the reasonability test becomes even more difficult if the adviser is able to use these directed soft dollars on services that benefit the ownership client and additional firm clients.

#### Question 4: Should post-trade analytics be considered order execution services

In that post-execution analytics can be used to determine the value of executing a transaction for future purposes, we believe that in these services should also be considered as "qualified" goods and services eligible for soft dollar expenditures.

#### Question 5: Difficulties with differential treatment of goods and services

If the list of "qualified" soft dollar services is substantially different than those available to U.S.-based advisers then we believe that Canadian advisers will be at a significant disadvantage to their southern counterparts. For example, if raw data feeds are excluded for Canadian advisers but not for those in the U.S. then Canadian managers who use raw data in their research process will have to charge higher investment management fees to international and U.S. clients than their U.S. peers. For smaller advisers these additional fees could result in lost mandates from non-Canadian clients. Moreover, Canadian plan sponsors and mutual fund companies may choose managers with lower investment management fees, leaving Canadian advisers with a shrinking asset base and increasing cost basis.

#### Question 6: Raw data as research

We believe that any input into the investment research process forms a mosaic that assists advisers in making investment decisions. Thus, any input utilized in this process should be considered research. In the case of raw data feeds we believe that all managers review trading activity in some format in order to assist them with the timing of an investment decision. Thus the use of raw data when used as part of the investment decision process is a valid form of research and the cost of these services is eligible for soft dollar payments.

If raw data is not being utilized as part of the investment decision process, then, like many other items, it should not be eligible for soft dollars.

If raw data is a component of a mixed-use service and the raw data of this service is not utilized, then the pro-rata portion of this data service should be excluded from the eligible expenses as outlined under the CFA Institute's soft dollar standards.

#### Question 8: Mixed use products as research

Our anecdotal evidence suggests that advisers use the majority of their soft dollar budgets on mixed use services such as Bloomberg, Reuters and Thomson Analytics. While we find some of these practices questionable, we do not dispute that, in most cases, these services are a bona fide research input for an adviser. Through our own use of these services and in discussions with clients we have found that while these services provide some impact in the research process they are used primarily for data aggregation, peer comparison and as a conduit for searching for additional industry and economic data.

What we find more egregious as mixed-use products are bundled research services provided by broker/dealers to advisers. In many cases we find that advisers will allocate almost their entire soft dollar budgets to the analysts at various broker/dealers, thus crowding out legitimate independent research services of the marketplace. A number of our clients have told us that they spend most of their soft dollars on bundled research in order to "keep the research pipeline open" or in order to get access to management of public issuers.

#### Question 9: Mass marketed information

We believe that advisers should have broad discretion with respect to their qualified soft dollar expenditures. However, the guidelines for disclosure of these expenditures should be explicit and insightful, thus making advisers accountable to their clients for these expenditures.

While there are some services that could be considered mass marketed, they are more limited in scope and thus should be considered as eligible for soft dollars. Examples of such services include services such as *Value Line* and newsletters such as *Bank Credit Analyst*.

General newspaper and magazine subscriptions should be excluded, but industry trade specific publications and newsletters which form part of an adviser's investment process should be included.

Seminars and professional development initiatives that provide advisers with educational opportunities to refine their investment decision making processes, and to generate new analytical methods or investment ideas should also be eligible for soft dollars. Investor day conferences sponsored by broker dealers should be eligible for soft dollar expenses so long as these expenses are reasonable in nature (a trip to New York or Atlanta for a North American media conference is reasonable, a trip to Aruba for a North American mining conference is probably not reasonable). A compromise solution may be to allow conference fees as the only form of eligible expenses for these items.

Question 10: What other goods and services should be considered order execution or research

Those services that aggregate financial and/or non-financial information which assist advisers in the investment research process should be considered eligible research for soft dollar expenditures.

The payment of costs for expert opinions used in the research process should also be considered as a research expenditure and thus eligible for soft dollars.

Question 11: Should form of disclosure be prescribed

We believe that the key components of disclosure should be prescribed and should be disclosed on both a firm-wide and client account basis. As we believe it would be difficult for advisers to itemize which specific services were used for an individual client account, a pro-rata portion based on average Assets Under Management of the client and firm would be sufficient for disclosure purposes. Where client specific information is available, it should be disclosed.

The items that we believe would constitute a minimum level of disclosure would be:

1. Total commissions charged to accounts
2. Total directed commissions charged to accounts
3. Total soft dollars earned by accounts
4. Total soft dollar expenditures made by firm
5. Soft dollar expenditures made by category:
  - a. Independent research
  - b. Mixed-use services
  - c. Broker/dealer research ("bundled" research)
  - d. Other

Moreover, on a firm-wide basis, each soft dollar vendor should be itemized and described in the disclosure document and include the total cost of each service (e.g., 17 Bloomberg terminals, data aggregation and analytical tools - \$100,000). In addition, a copy of the company's soft dollar policy should be attached to this disclosure statement

Question 13: Periodicity of disclosure

Disclosure of soft dollar expenditures should be provided on at least an annual basis or as often as the client and adviser complete a performance review.

Question 14: Problems with adviser disclosures

We believe that most advisers would face difficulty in disclosing brokerage commissions paid on a client's account on a security class basis. While larger advisers may be able to develop this information, smaller advisers would not have the technical capabilities to develop and provide this information to clients.

We thank you for the opportunity to express our thoughts on this very important matter. Please feel welcome to contact me at the address above if you have any further questions.

Yours truly,  
ACCOUNTABILITY RESEARCH CORPORATION

A handwritten signature in black ink, appearing to read 'Mark Rosen', with a long horizontal flourish extending to the right.

Mark Rosen, CFA