HILLSDALE

October 26, 2006

British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Financial Services Commission
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Nova Scotia Securities Commission
Prince Edward Island Securities Office
Securities Commission of Newfoundland and Labrador
Registrar of Securities, Department of Justice, Government of the Northwest Territories
Registrar of Securities, Legal Registries Division, Department of Justice, Government of Nunavut
Registrar of Securities, Government of Yukon

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

- and -

c/o Anne Marie Beaudoin
Directrice du secrétariat
Autorité des marchés financiers
Tour de la Bourse
800 square Victoria
C.P. 246, 22e étage
Montréal, Québec
H4Z 1G3

Dear Sirs/Mesdames:

Re: Hillsdale Investment Management Inc.'s Comments on Proposed National Instrument 23-102 *Use of Client Brokerage Commissions as Payment for Order Execution Services or Research ("Soft Dollar" Arrangements)*

This letter is being written on behalf of Hillsdale Investment Management Inc. ("Hillsdale") to provide our comments to you on proposed National Instrument No. 23-102 *Use of Client Brokerage Commissions as Payment for Order Execution Services or Research ("Soft Dollar" Arrangements)* ("NI 23-102").

Hillsdale is a leading practitioner of alternative investment strategies and offers one of the most sophisticated and disciplined equity management approaches in Canada. It currently manages and advises on over CAD$300 million of investor assets in both the private client and institutional markets, composed mainly of equity hedge funds covering the North American markets. Hillsdale was incorporated on January 5, 1996.

Hillsdale is a member of the Canadian chapter of the Alternative Investment Management Association (AIMA), the Investment Counsel Association of Canada (ICAC) and the Association of Canadian Pension Management (ACPM). The principals of Hillsdale are members of The CFA Institute (formerly known as the Association for Investment Management and Research or AIMR).

Hillsdale's investment methodology is based on a cycle of continuous improvement utilizing a platform featuring proprietary databases, investment applications, simulation software and financial modelling systems. The investment process is fully integrated across research and stock selection processes, portfolio construction and optimization techniques, the active portfolio, risk and factor monitoring and performance measurement and evaluation reporting. All components of the process are tied together through various feedback loops. The process is dynamic, consistent, repeatable and risk controlled. The search for new variables and factors that either predict or control equity returns is ongoing and involves the use of many primary data sources.

Organization

This letter outlines our general thoughts and major points with respect to NI 23-102. We have organized this paper as follows:

> ***General Principles***
> ***Specific Changes Required, with supporting rationale***
> ***Conclusion***
> ***Attachment A – Responses to specific questions posed by the CSA***

General Principles

Hillsdale supports this CSA initiative to update the Ontario Securities Commission (OSC) Policy 1.9 and the Autorite des marches financiers (AMF) Policy Statement Q-20 in light of industry and international developments and to ensure a consistent application of principles across Canada. However, we disagree with several aspects of the proposed implementation in order to achieve the stated goals. Our areas of disagreement are outlined in this paper.

Hillsdale believes that the following principles should guide the standards on the usage of commission dollars:

1. **Commissions belong to the client. Their usage is already governed by the adviser's fiduciary responsibility to act in the best interests of the client.**
2. **Any activity that assists in reducing the overall cost of execution is beneficial to the client and should be seen as a legitimate use of commission dollars. The cost of execution is comprised of both direct (commissions) and indirect costs (primarily market impact) and the direct costs are by far the smaller of the two components.**
3. **Utilizing usage-based principles, advisers are the only party that can decide if a service or form of information offers value or not, and so must be the arbiter of what information and services are relevant to their investment decision-making process.**
4. **Adequate and regular disclosure by advisers to all of their clients will ensure that the interests of advisers and investors remain aligned and that advisers have fulfilled their fiduciary duties.**
5. **Regulations should promote a free, open and fully competitive market in all respects. They should not discriminate in favour of one business model over another.**

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Commissions belong to the client. There should always be a clear understanding between the client and adviser as to how commissions are to be used, along with clear and meaningful disclosure and reporting. This principle governs Hillsdale activities with respect to commissions. We believe that this is consistent with the CSA initiative.

Any activity that assists in reducing the overall cost of execution is beneficial to the client and should be seen as a legitimate use of commission dollars. Hillsdale believes that it is important to understand the overall trading process components, including commissions, and the costs inherent in managing assets for clients. The comments below are based on over 10 years of experience in managing client equity investments and over 3 years of collection of real-time data on pre- and post-trade analytics.

The overall objective of any adviser is to manage the total execution costs in as efficient and cost effective manner as possible. Execution costs include two main components: direct costs and indirect costs. Direct costs include commissions (and for our purposes will include research and execution services) while indirect costs include both timing risk and market impact. Independent studies, performed by Plexus Group (2003) and Accenture Financial Services (2005) both indicate that direct costs are less than 20% of the total cost. Analysis performed by Hillsdale of its own trade data reaches a similar conclusion as our direct costs have generally run around 15%. Given that our research is included in the commission amount and is less than half of this figure, it represents an even smaller share of the total cost at less than 10%. As such, indirect costs are by far the largest component of execution costs, representing roughly 80% of the total.

The CSA must recognize this as the true cost structure that every investor faces. Focusing on only one component and restricting expenses in only one area (research) will be of limited benefit to investors. By focusing only on research, which is the smallest component, the least benefit will be achieved. By precluding other legitimate execution services such as hardware that supports connectivity and direct market access and algorithmic platforms, regulators are handcuffing advisers as they attempt to target the largest line item expense: indirect costs. The current policy, as written, discriminates directly against advisers who attempt to seek alternative methods to trade and further reduce execution costs. Worse, the policy favours broker business models which are allowed to directly pass the exact same costs through to investors and to do so in a bundled and non-transparent cost structure.

Utilizing usage-based principles, advisers are the only party that can decide if a service or form of information offers value or not. The proposed instrument defines research to include "analyses or reports concerning securities, portfolio strategy, issuers, industries, or economic or political factors and trends," and goes on to require that such analyses or reports **add value** to investment or trading decisions by including "the expression of reasoning or knowledge and contain original thought", which "involves the analysis or manipulation of data to arrive at meaningful conclusions."

Hillsdale fundamentally disagrees with any attempt, in an increasingly complex and rapidly changing world and industry, to specifically define or codify what characteristics of information add value. A marketplace for research, or any other product, is made up of individuals and institutions that have different views, objectives, strategies, risk tolerances, individual profiles, life cycles, time horizons, tax considerations, income requirements, liquidity parameters, return objectives, behavioural biases, ethical beliefs etc. Therefore, research as made readily available in a free market place must be amenable to satisfying each and every preference. Restrictions on the definition of research will only impair the ability of the market place to function effectively and efficiently by penalizing certain aspects of the market that have differing views on what defines "original thought, expression of reasoning or knowledge."

To suggest that the marketplace has, or worse, that a market place should have, a uniform view of what is 'value added' is contrary to efficient market behaviour. The key point is that advisers must understand what factors they think drive stock or asset prices. Any information, research or analysis that provides further insight into these factors would be considered critical to any investment decision-making process. Therefore, advisers must remain completely unencumbered by specific definitions of research and must be free to pursue any avenue available to them and any angle that will assist them in obtaining an edge in the marketplace. Regulators can do great harm to a market by attempting to limit such choices, especially for smaller managers.

In addition to the above, to go on to suggest, as does Section 3.3 of the Companion Policy, that "Information or conclusions that are commonly known or self evident would not qualify," assumes that a consensus on the world exists and that this information can be easily gleaned or read in a summary sheet somewhere. Markets do not function in such a manner. For every one investor that believes the market will rise tomorrow or over the near term, one can easily find another intelligent, reasoned investor who believes the opposite. In our view, to extend this assumption of a consensus to mean that mass marketed publications do not add value for an adviser does not reflect market realities. (Please see our additional comments in Attachment A.)

Given the above we believe that an adviser is best placed to determine what constitutes "added value" and must be free to select the tools that it feels will aid in achieving this goal, subject to its fiduciary duty to its clients. In Hillsdale's opinion it does not serve investors for regulators to prescriptively limit research tools, such as pre- or post-trade analytics, raw data, seminars, mass market publications or any other specific research item.

The competitive nature of the asset management industry will serve to reduce potential abuses. Advisers have clear incentives to minimize any cost to the investment portfolio and to ensure that any expense that is incurred has been incurred by necessity or in order to ultimately help improve performance. Otherwise returns will be negatively impacted, reducing an adviser's ability to attract assets and reducing its compensation. This ensures that the interests of an adviser are aligned with its clients.

Adequate and regular disclosure by advisers to all of their clients will ensure that the interests of advisers and investors remain aligned. Disclosure to investors and clients of an adviser's use of commissions is important to show clients that such amounts have been used effectively for their benefit and in accordance with the adviser's fiduciary duty to act fairly, honestly and in good faith.

However, any disclosure must be consistent with other client information (without disclosing proprietary information), be easily understood by the investor and be capable of being provided by the adviser in a cost effective manner.

Regulations should promote a free, open and fully competitive market in all respects. They should not discriminate in favour of one business model over another. The current proposal allows the obtaining of some goods and services through a broker as bundled research to be eligible

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for commission dollars while disallowing the same or a comparable expense if it is obtained by the adviser directly.

In our opinion the current approach severely skews the competitiveness of the market, both domestically and internationally. We believe that the proposed standard does not meet the Vision or Mandate of the Ontario Securities Commission as outlined in the 2006 Annual Report, specifically:

"Vision – Canadian financial markets that are attractive to domestic and international investors, issuers and intermediaries because they are ***cost-efficient*** *and have integrity.*

Mandate – To provide protection to investors from unfair, improper or fraudulent practices and ***to foster fair and efficient capital markets*** *and confidence in their integrity."*

(emphasis added)

Regulators must recognize that in today's world both research and execution services offered by full service brokerage firms can be almost 100% dis-intermediated. It is imperative that advisers have the full scope and flexibility to manage money without requiring recourse to the current full service brokerage business model. The broker model provides a myriad of services and information in an opaque and bundled structure where all costs are rolled into one simple price: a commission. For example, hardware that promotes connectivity, supports direct market access, reduces latency and provides algorithmic tools can all be included within the execution cost of a broker and are expensed directly to investors via a commission. Furthermore, broker research can include any service or information that they may choose as inputs, whether it be raw data, publications, mass distributions or conferences. All such costs are included within broker research and expensed directly to investors via a commission. If an adviser accesses any of these services via a broker or other middleman, they are considered legitimate and can be purchased using commissions.

However if an adviser elects to avoid the middleman by accessing such items directly on its own to conduct independent research, build proprietary tools etc. then in the proposal these costs are considered unacceptable and cannot be charged to investors via commissions. This is patently unfair and anticompetitive. Advisers should be not be precluded from building proprietary tools and techniques from a variety of independent sources using client commissions.

Forced selection from only one provider or restrictions on competitive access to products and services increases costs and reduces competition or fairness and reduces efficiencies.

Specific Changes Required

The comments below are with respect to specific items that Hillsdale believes that require change and are particularly important:

1. **Hillsdale believes that the adviser, in the exercise of its fiduciary duty to investors, is best placed to determine what adds value to the processes. The standard should not attempt to define what processes or tools "add value" to research and what tools or processes do not, particularly by stating that they must "include the expression of reasoning or knowledge and contain original thought." In our opinion the determination of which goods and services can be acquired using commission dollars should be principles- or usage-based, coupled with meaningful disclosure.**

2. **Raw data must be eligible for commission dollar payment. Its exclusion in the proposed standard discriminates against advisers who utilize quantitative, technical, momentum, statistical arbitrage or higher frequency strategies. Such discrimination will severely impact these advisers ability to conduct business, thereby reducing competition and investor choices in Canada.**

3. **With respect to competition, the standard must ensure that there is a level and competitive playing field for <u>all</u> participants, domestic and international, in the Canadian market. This is particularly important vis a vis U.S. based advisers.**

4. **Disclosure to investors on how the commission dollars have been used should be consistent, informative and meaningful, balanced against the maintenance of each firm's proprietary competitive advantage. Meaningful disclosure supports a usage-based determination of permitted goods and services.**

5. **A transition period is required for implementation of the final rule, similar to previous CSA practice and consistent with the approach in other jurisdictions.**

Our comments below and in Attachment A are made with reference to the above.

<u>The adviser, in the exercise of its fiduciary duty to investors, is best placed to determine what adds value to the order execution and investment decision-making processes. The determination of permitted goods & services should be usage-based.</u>

Hillsdale supports the goal of ensuring that there is clarity for investors with respect to which goods and services can be acquired by advisers utilizing client commission dollars.

Hillsdale's investment decision making process is a fully integrated and comprehensive structure that includes research, risk management, strategy, and execution and performance attribution. It is fully inclusive of both research and brokerage as defined by the CSA and aspects of each are embedded within various stages of the process. Our process is continuous and its continuity and integration across the decision making spectrum is part of our firm's competitive edge in the marketplace. Achieving such integration has been a business objective of ours over the 10 years since our founding.

This reflects the fact that the investment decision-making process, including order execution and research, occurs on a continuum or in a circle. It is not a linear process with easily identifiable starting and stopping points. Similar to any process in the business world, undertaking these activities is a circle of: Plan (make the investment decision using a wide range of inputs); Do (execute the decision); Review/Check (analyze the process and its effectiveness); and Act/React (amend the process to incorporate improvements). It goes full circle and starts again at Plan.

Given the above, in our view it can be extremely difficult to identify starting and stopping points for processes and disagree with the assumption in the proposal that this is always possible. We believe that an example of this difficulty is reflected in the proposal whereby pre-trade analytics is considered part of order execution and post-trade analytics is considered part of research. In our view both are part of the overall process of investment decision-making and their categorization as order execution or research is secondary.

The integration of the processes is increasing with the introduction of advanced execution technologies, including electronic trading, direct order routing, algorithmic trading and the introduction of alternative liquidity pools. We would argue that the line between order execution services, research and strategy will blur completely with the development of higher frequency trading strategies. These strategies are increasingly common in the US and the UK and will start to evolve in Canada as the technologies become further disseminated. Given this trend, defining order execution based only on a 'temporal limitation' will become very difficult, if not impossible.

Given the above, Hillsdale believes that determining permitted goods and services is best achieved through utilizing a usage-based definition, as promulgated globally by The CFA Institute as part of its guidance on the use of client brokerage or commissions. This principles-based approach to defining allowable expenses focuses on how the goods and services are actually used by the adviser. Coupled with a robust and meaningful disclosure regime, Hillsdale believes that this would meet the goals of the CSA and better serve investors. The professional standards of The CFA Institute govern the professional and ethical duties of Hillsdale and its principals.

Under this approach all inputs to the "Investment Decision-Making Process" (as defined by The CFA Institute) that directly assist the adviser in rendering investment advice to clients can be purchased using commission dollars. Attempts to delineate the starting or stopping points of processes are not required because they are not meaningful.

We believe that market pressures (e.g. due diligence by institutional investors, analysis of competitive returns), investor disclosure and regulatory processes (e.g. inspections) serve to reduce the potential for abuses under such a usage-based system.

Such an approach potentially affects items such as publications and seminars, dedicated hardware and software etc. Please see our comments in Attachment A with respect to specific items.

In summary, we believe that it is the primary and fiduciary duty of the adviser to choose what adds value to the investment decision-making process. As the provider of service to the investor the adviser is best placed to make such decisions, employing a usage-based approach. Attempts by regulators to define or prescribe research, e.g. requiring original thought, could impair competition.

<u>Raw data must be eligible for commission dollars. Its exclusion in the proposed standard discriminates against advisers who utilize quantitative and other management techniques.</u>

Hillsdale believes that raw data should be a permitted good or service. This reflects the principles outlined above that the adviser is best placed to determine what adds value and that the market should not discriminate in favour of certain business models.

In order to utilize its quantitative-based investment management approach, Hillsdale uses large databases encompassing hundreds of variables over decades of time. These databases are analyzed through statistical techniques to identify variables that indicate whether or not a security is a desirable investment. The proposed requirement that research include original thought or the expression of reasoning or knowledge ignores the fact that raw data is the key input to many advisers' investment decision-making. The ability to utilize the data to perform backtests or simulations *in order to determine an independent investment strategy* is key. Many of Canada's largest and most successful advisors are quantitative in their approach.

Raw data also facilitates research by an adviser on specific items and their market impact. For example, in order to assess ways to reduce exposure to potential fraud by identifying warning indicators, an adviser may wish to study daily market trading patterns as information was disclosed to the market in cases where fraud has occurred, e.g. Enron, Worldcom, Bre-X, YBM Magnex. Such a study requires that the adviser obtain raw price data. Such data can be scarce, and in our experience some vendors have incomplete databases.

Paying vendors to obtain raw data has value (a) in obtaining access; and (b) in allowing the adviser the ability to study and analyse the data. Various providers, such as Reuters and its many competitors, spend a great deal of money collecting, scrubbing, aggregating and distributing data from markets all over the world in order to deliver such value. Arm's length customers often pay thousands of dollars for such databases and ongoing updates.

In fact, as clearly demonstrated by its market price, the true value of good, clean raw data is significantly higher than much of what qualifies as research or "original thought or expression" today.

Given the above we believe that it is inconsistent for the standard to implicitly state that research or reasoning performed by a broker or third party (which itself utilizes raw data inputs) is superior to that performed by an adviser itself. We fully support the SEC's view on research and the arguments put forth on July 18, 2006 in Release No. 34-54165; Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, section III. C. 3. Market Research and 4. Data that includes the following observation on the eligibility of raw data as research: **"In our view, this approach will promote innovation by money managers who use raw data to create their own research analytics, thereby levelling the playing field with those money managers who buy finished research, which incorporates raw data, from others."**

The guidelines as currently written openly discriminate against certain management styles, notably, quantitative, technical, momentum, statistical arbitrage or higher frequency strategies that are heavily reliant on both data and technology for their value add. The proposed regulations would have the impact of favouring non quantitative or discretionary advisers. Such an approach would restrict the products and choices available to investors.

We believe that such an approach, if not amended, runs counter to the OSC Mandate to "foster fair and efficient capital markets."

Hillsdale submits that raw data adds value to the investment decision-making process, promotes competition and widens investor choice, and so must be eligible for purchase utilizing commission dollars. The inclusion of a statement in the instrument, as exists in Policy Statement 1.9, that permitted goods and services include "databases or software to the extent that they are designed mainly to support order execution services or research" would achieve this aim.

<u>The standard must ensure that there is a level and competitive playing field for all participants, domestic and international, in the Canadian market.</u>

This requirement clearly supports Organizational Goal #4 of the Ontario Securities Commission as outlined in the 2006 Annual Report, specifically "Work to achieve appropriate regulatory integration of North American and global capital markets."

Canadian advisers must compete on a global basis, working from a relatively small base, so it is important that any regulatory regime not create obstacles to their ability to compete effectively. The Canadian market is a small proportion of international activity, with the U.S. and the UK/EU constituting the bulk of such activity.

Effective harmonization must ensure that Canadian advisers are not disadvantaged through the imposition of a higher level of costs due to regulatory requirements versus competitors in other countries. Creation of a higher Canadian cost structure will inevitably increase investor costs and reduce investor returns or available choices. As previously mentioned a usage-based system would help to ensure harmonization.

Standards should also ensure that there is a level competitive playing field between Canadian and U.S. advisers. In our opinion it is inappropriate for regulations to be materially different from other major competitive jurisdictions without a clear justification (e.g. structural market differences) for doing so. For example, as the proposal stands a U.S. based adviser would be able to utilize commission dollars to purchase various research services such as raw data and publications while a Canadian adviser would not. The result is that the Canadian adviser would be uncompetitive as it may not purchase such services, thereby potentially not providing the best possible service to investors, or it would be forced to raise its fees to cover such costs. In the former case investors are deprived of the best possible service, in the latter case investor costs are increased. Alternatively the Canadian adviser might leave Canada and set up business elsewhere, resulting in a loss to the Canadian economy. The net result is that money management mandates could end up leaving Canada and reduce the size of the Canadian advisory industry.

Since the majority of Canadian economic activity is conducted with the U.S., and that the primary competition for Canadian money managers comes from the U.S., the draft instrument should not disadvantage Canadian advisers, particularly with respect to what goods and services qualify for payment with commission dollars.

The proposed Canadian exclusion of some goods and services that are allowed in the U.S. as permitted commission dollar expenses places Canadian advisers at a competitive disadvantage. The net result is that the cost base of the adviser would increase, which would be reflected as increased costs or fees to investors. This should not be allowed to happen and is contrary to stated regulatory goals.

<u>Disclosure to investors on how the commission dollars have been used should be consistent, informative and meaningful, balanced against the maintenance of each firm's proprietary competitive advantage.</u>

Under a usage-based approach for determining eligible approaches, disclosure to investors and clients of an adviser's use of commissions is important to show clients that such amounts are used effectively for their benefit and in accordance with the adviser's fiduciary duty to act fairly, honestly and in good faith.

However, any disclosure must be consistent with other client information, be easily understood by the investor and be capable of being provided by the adviser in a cost effective manner. It is important to note that disclosure has costs attached, both in monetary terms and in time requirements, the latter not only on the part of the adviser but also on the part of the client to understand the disclosure. There must be an effective balance between costs and benefits. Assuming disclosure requirements are applied equally through the whole industry, the costs of providing disclosure will ultimately be borne by the investor.

In our view the proposed level of disclosure, particularly the requirement to drive it down to the individual client level, is more than is required to achieve the stated goals. We would point out that research is generally purchased on a macro basis and therefore an allocation process would be required to report the costs at an individual client level. Given how trading costs are generally managed in the industry (e.g trades are aggregated across portfolios to ensure best execution), any such level of detail would also require a cost allocation process that would have to be developed by each adviser to reflect their business. Any such methodology will only be as good as the assumptions used to allocate the costs, which will differ from firm to firm and are subject to discretion and judgement. Thus any attempt at comparability between advisers becomes questionable and clients are likely to assume that there is a greater level of accuracy than actually exists. Hillsdale believes that disclosure at the level of the adviser in total would be sufficient for investors to assess how commission dollars are employed.

In addition to the above, we do not believe that the proposed requirement to break out the commissions by supplier, and then for each supplier by type of instrument, with further subdivisions between order execution, research (both direct and bundled) and third party services would add significantly to investor understanding of costs. In our view it is also inappropriate to require a greater level of disclosure with respect to goods and services obtained from third parties, where a further breakdown is proposed, than for bundled services. In our opinion distinguishing research by source rather than content does not increase investor understanding.

Presenting the ratio of the costs to the assets managed would have the benefit of consistency with the determination of the Management Expense Ratio or MER and allow comparability between advisers versus results achieved. This would be instead of disclosing cost/share information.

Hillsdale's opinion is that the proposed requirement to disclose the specific suppliers of goods and services violates accepted norms of business confidentiality by forcing the disclosure of proprietary information. The vetting and development of supplier relationships can be a large part of an adviser's competitive advantage. Disclosure of such detail places the adviser at a competitive disadvantage, particularly with respect to foreign competition that does not have a comparable disclosure requirement.

In our opinion sufficient and meaningful disclosure should include the total commission costs, segregated between order execution and research, a general description of the type of goods and services purchased, along with the ratio of the costs to the assets managed. This analysis should be presented on a total adviser basis.

Disclosure of supplier specific information is contrary to business confidentiality and is not required for investor understanding of costs.

The standard should include a transition period for implementation.

We believe that the proposal must include an implementation or transition period, as is the norm with other CSA standards as they are brought forward. It is important that advisers have a time period in order to amend their policies, procedures and processes to comply with the standard. The implementation of some of the proposals could potentially require a significant amount of resources and time, such as the creation of a whole new client disclosure system.

If a transition period is not allowed an adviser risks being deemed to be in violation of the rules before they have a definitive understanding of what the rules are.

Conclusion

While Hillsdale supports the overall general goals of the policy initiative, we believe that there are fundamental points that require change in order to align the implementation of the standard with the general principles that should govern the use of commission dollars. Specifically:

1. **Hillsdale believes that the adviser, in the exercise of its fiduciary duty to investors, is best placed to determine what adds value to the investment process. The standard should not attempt to define what processes or tools "add value" to research and what tools or processes do not, particularly by stating that they must "include the expression of reasoning or knowledge and contain original thought." In our opinion the determination of which goods and services can be acquired using commission dollars should be principles- or usage-based, coupled with meaningful disclosure.**

2. **Raw data must be eligible for commission dollars. Its exclusion in the proposed standard discriminates against advisers who utilize quantitative, technical, momentum, statistical arbitrage or higher frequency strategies as well as against advisors who develop their own research analytics. Such discrimination will change the way these advisers conduct business, driving them back to full-service brokers to purchase research at much higher aggregate cost. This concentration will further reduce competition and investor choice in Canada.**

3. **With respect to competition, the standard must ensure that there is a level and competitive playing field for <u>all</u> participants, domestic and international, in the Canadian market. This is particularly important vis a vis U.S. based advisers.**

4. **Disclosure to investors on how the commission dollars have been used should be consistent, informative and meaningful, balanced against the maintenance of each firm's proprietary competitive advantage. Meaningful disclosure supports a usage-based determination of permitted goods and services.**

5. A transition period is required for implementation of the final rule, similar to previous CSA practice and consistent with the approach in other jurisdictions.

We appreciate the opportunity to provide the CSA with our views on this proposal. Please do not hesitate to contact the following with any comments or questions that you might have. We would greatly appreciate the opportunity to meet with you in order to discuss our comments:

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Arun Kaul, Chief Operating Officer (416) 913-3916 akaul@hillsdaleinv.com

Ian Pember, Vice-President Administration (416) 913-3920 ipember@hillsdaleinv.com

Yours truly,

Chris Guthrie, CFA
Chief Executive Officer

Arun Kaul

Arun Kaul, CFA
Chief Operating Officer

ATTACHMENT A
PROPOSED NATIONAL INSTRUMENT 23-102
HILLSDALE COMMENTS RE SPECIFIC QUESTIONS

Question 1:

Should the application of the Proposed Instrument be restricted to transactions where there is an independent pricing mechanism (e.g., exchange-traded securities) or should it extend to principal trading in OTC markets? If it should be extended, how would the dollar amount for services in addition to order execution be calculated?

In our opinion the proposed instrument should apply to any transaction where a demonstrable transaction based fee can be determined *or reasonably estimated*. This could be achieved by monitoring the bid/ask spreads and assessing the services provided by a broker or dealer in relation to the volume of trading in OTC markets. At the very least, participants in OTC markets should begin to disclose the amount and type of goods and services procured through their brokers.

It is patently unfair for advisors dealing in public markets to have their commission expenditures monitored so closely while those in OTC markets do not. Some may consider the rise in private equity investing and the increased availability of OTC "equity-like" instruments as evidence of the quiet erosion of public markets.

Question 2:

What circumstances, if any, make it difficult for an adviser to determine that the amount of commissions paid is reasonable in relation to the value of goods and services received?

It is difficult to determine reasonableness when services are bundled with order execution and are not separately priced, as occurs with full-service brokers.

It could be more difficult to determine if commissions are reasonable for the value received if an adviser tends to execute transactions with one dealer, either exclusively or in a majority of transactions, particularly if the adviser is small or just starting up. However, we believe that given the highly competitive nature of the Canadian and North American markets this risk is minimal and any adviser should be able to easily demonstrate that commissions paid are reasonable with respect to those paid, or that would be paid, to other dealers. This would be particularly important when such goods and services are obtained from non arms length parties.

Question 3:

What are the current uses of order management systems? Do they offer functions that could be considered to be order execution services? If so, please describe these functions and explain why they should, or should not, be considered "order execution services".

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Order management systems are generally used to handle an order from the time an investment decision has been made until it settles, including order entry and routing, messaging, execution tracking, pre and post trade analytics. Such systems are generally put in place in order to streamline the execution components of the investment process, allowing for its continuous review and improvement in order to reduce the overall costs of trading. In our opinion any component of an OMS that facilitates the placement and settlement of an investment order and allows for improvement and monitoring of the process should be eligible for payment by commission dollars. Please note our comments below on question #4 with respect to post-trade analytics.

Question 4:

Should post-trade analytics be considered order execution services? If so, why?

We believe that post-trade analytics, as well as pre-trade, are all part of one continuous process and should be considered permitted goods and services. In our view they are a key part of analyzing the indirect or slippage costs within the trading process. Similar to any process in the business world, undertaking an activity is a continuum of: Plan (make the investment decision); Do (execute the decision); Review/Check (analyze the process and its effectiveness); and Act/React (amend the process to incorporate improvements). Post-trade analytics are part of the Review/Check stage of the process. In our view excluding post-trade analytics would be analogous to not considering feedback from a teacher to be part of the education process.

Question 5:

What difficulties, if any, would Canadian market participants face in the event of differential treatment of goods and services such as market data in Canada versus the U.S. or the U.K.?

The key difficulty arising from a differential treatment of goods and services would be a potential decrease in the ability of Canadian advisers to compete for business, particularly large institutional mandates. If a foreign adviser, e.g. in the U.S., is able to utilize commissions to pay for a service while a Canadian adviser is not, then the Canadian adviser must either absorb the cost of such services as a fixed cost reducing its profit margin, or increase its fees. Either scenario impairs the Canadian ability to compete with non-resident managers.

This is especially important with respect to the eligibility of raw data. In our view not allowing it in Canada, while it is allowed in the U.S., will effectively reduce the provision of such services by Canadian advisers and allow the market to be served mainly by U.S. based advisers.

Besides this impairment of competitive ability, the asset management business can be considered fairly transportable, and so any long term decline in profitability has the potential to encourage Canadian advisers to move to other jurisdictions where the regulatory regime enhances, or does not hurt, their ability to compete.

In summary Hillsdale believes that definitions should be conformed to ensure a level, competitive playing field, particularly with the U.S. as Canada's largest trading partner.

Question 6:

Should raw market data be considered research under the Proposed Instrument? If so, what characteristics and uses of raw market data would support this conclusion?

Raw market data should be considered research under the proposed instrument. If this data is excluded from the definition of research the regulatory regime is in the position of discriminating against quantitative, technical, momentum, statistical arbitrage or higher frequency strategies, all of which utilize such data to construct their models and to conduct back testing. This would mean that the regulators are in the position of influencing what is available to the investor in the market, rather than letting the market determine. We submit that this is not an appropriate role for a regulator to play and violates the principle of creating an open and competitive market.

We believe that the market has already indicated that the provision of raw data has great value. This is evidenced by the fact that various providers, such as Reuters and its many competitors, spend a great deal of money collecting, scrubbing, aggregating and distributing data from markets all over the world to arm's length customers who are willing to pay significant sums for such a service. There is great value to the end investor in the efficiency gains to the adviser in being able to obtain such data to support the process of formulating investment recommendations. Such services certainly result in lower costs than if the adviser attempted to obtain and aggregate such data itself.

The proposal as it stands could lead to the situation that if a quantitative-based adviser purchases raw data directly in order to construct its models it does not qualify for commission dollars. However, if an independent research provider buys the data, tweaks it in some fashion and then sells it to the quantitative adviser, it presumably could qualify for commission dollars. This means that the regulatory regime encourages the insertion of a middleman into the process, with a likely increase in the ultimate costs to the investor. In our opinion research is research, and any item that supports the investment decision-making process should be allowed, irrespective of whether the original thought and expression of reasoning and knowledge is conducted by a third party or by the adviser utilizing raw data to draw its own conclusions. The determination of whether there is added value should be the domain of the adviser and eventually, the market.

We would also point out an inconsistency in the proposed approach in that Section 3.2 of the Companion Policy specifically states that algorithmic trading software, if it assists in order execution, would qualify for commission dollars. However, algorithmic software functions based on the inflow of raw market data. This functional requirement is increasing with the development, for example, of neural networks and fuzzy logic to determine what investments will be made. We believe that if such systems are used for order execution and investment decision making as part of an integrated process, then all components should be eligible for payment by commission dollars, subject to the adviser being able to demonstrate that such systems are utilized for the benefit of the client.

In summary, in our opinion raw market data should be considered research as long as it can be shown by the adviser that it is part of, or an input to, the investment decision making process and adds value. Similar to our comments above with respect to question #4, research is a process and all of its components should be permissible goods and services.

Question 7:

Do advisers currently use client brokerage commissions to pay for proxy-voting services? If so, what characteristics or functions of proxy-voting services could be considered research? Is further guidance needed in this area?

At Hillsdale we do not use commission dollars to pay for proxy voting services.

However, in some circumstances, proxy voting services could qualify as research. Some providers of such services, such as Institutional Shareholder Services (ISS), offer data from their proxy voting databases on trends in corporate governance as reflected by shareholder voting. Research studies in the industry have indicated correlations between corporate governance and share prices, and so such data could be an input to investment decision making models.

As stated previously, we believe that the definition of what constitutes research should be driven by basic principles rather than prescriptive detail. Therefore such costs could qualify for commission dollars as long as the adviser can demonstrate the relationship to the investment decisions.

Question 8:

To what extent do advisers currently use brokerage commissions as partial payment for mixed-use goods and services? When mixed–use goods and services are received, what circumstances, if any, make it difficult for an adviser to make reasonable allocations between the portion of mixed-use goods and services that are permissible and non-permissible (for example, for post-trade analytics, order management systems, or proxy-voting services)?

Mixed use goods and services can form an important part of purchases with commission dollars. When there are mixed use goods and services it can be difficult to make an allocation of costs when the item consists of a tightly integrated system where one element is not easily separable from another. The first step is generally to talk to the external supplier, if there is one, to attempt to get some idea of the relative cost components. If that is not possible the adviser can make a determination for allocation and document the rationale accordingly, as the proposal indicates.

We believe that this is the only reasonable approach. However we would note that as long as such an approach can be shown to have been done in good faith and is reviewed regularly it should not be subject to second guessing upon review by another party.

Question 9:

Should mass-marketed or publicly-available information or publications be considered research? If so, what is the rationale?

We believe that such information should be considered research. *The fact that it is mass marketed and/or lower cost is reflective of the efficiency of the market in delivering information, not whether it has value to an adviser.* In our opinion it is better for an investor, due to lower costs, if an adviser can obtain market and corporate information from such publications versus paying more to a dealer via commissions to obtain the same information.

Publications such as Barron's and the Wall Street Journal can and do include exhaustive analysis and research and in many cases produce information that is relevant to an investor decision-making process. Perhaps most importantly, they provide information that can move markets. Weekend research pieces in Barron's regularly move stocks on Monday.

Similarly, industry publications and conferences or seminars can be an integral part of the research process and can deliver large value for cost. They contain articles by or feature speakers that are some of the industries most respected academics and practitioners. In some cases, due to regulation governing public disclosure, industry leaders will only address the adviser community through public seminars where everyone has equal access.

The CFA Institute as well as many other institutions host conferences that regularly feature industry leaders, some of whom are influential in shaping generally accepted practices, discussing cutting edge topics or offering insight into various industry metrics, many of which pertain directly to the investment decision-making process. The research of many of these individuals, such as Peter Bernstein, Keith Ambachsteer, Arthur Laffer or Myron Scholes, have formed an important component of industry literature. In our opinion it is inconsistent to suggest that an article or presentation by one of them would not qualify as a value-added input given that some of their research has lead the industry forward and/or been awarded a Nobel prize.

Hillsdale's view is that it is better for the investor if an adviser is able to purchase a publication or attend a conference directly, having access to the opinions of multiple analysts, than to pay full-service brokers for access to each analyst individually. The proposal as drafted would allow the full-service broker or analyst to attend the same conference and pass through the cost, via commission, as part of their product offering..

Question 10:

Should other goods and services be included in the definitions of order execution services and research? Should any of those currently included be excluded?

As indicated by our general overview and responses to other specific questions, Hillsdale believes that the correct approach to ensuring the appropriate use of commission dollars is to establish key principles, based on use, to govern what goods and services can be purchased with them and to ensure adequate disclosure to investors of the usage of such dollars by the adviser.

We believe that, following this approach, various items (see our responses to questions 4, 6, 7 & 9) should be included. **In our opinion permitted goods and services should also include, for example, hardware and communication lines as long as the adviser can demonstrate dedicated usage by the order execution or research processes.**

Banning execution services such as hardware employed for connectivity used to facilitate electronic trading and direct market access again favours brokers and discriminates against advisors. For example, every broker has a direct connection with the TSX so that they can trade electronically on the floor. Direct market access is now 'sold' to advisors that wish to trade independently of the broker and assume direct control of their trades. In such circumstances, advisors access the brokers 'pipe' and go directly to the floor of the exchanges. This is not a service that brokers provide for free as it is costed as part of their execution services and then charged to the advisor as a commission expense. However, if an advisor were to choose to build a direct connection to the exchange (a very common occurrence in the U.S.), to achieve direct market access and bypass the broker completely, the hardware costs associated with achieving full connectivity would be precluded from execution services. This is clearly unfair.

Notwithstanding the above, we agree that some items do not facilitate the investment decision-making process and should be excluded from permitted goods and services. Such items would include:

-Office furniture & equipment
-Marketing services and club memberships
-Computer software that assists with administrative functions
-Legal and accounting services

We do not see any items currently proposed for inclusion that should be excluded.

Question 11:

Should the form of disclosure be prescribed? If prescribed, which form would be most appropriate?

We do not believe that the form of disclosure should be prescribed but rather that the adviser and its clients should determine what is reasonable. However we believe that it is important, when specific data is required to be disclosed by any National Instrument, for the CSA to provide a suggested format that it believes would meet the requirements, while making clear that it is not mandatory. This would provide some guidance from which advisers could determine their own form of disclosure.

Question 12:

Are the proposed disclosure requirements adequate and do they help ensure that meaningful information is provided to an adviser's clients? Is there any other additional disclosure that may be useful for clients?

We believe that the level of proposed disclosure is too detailed and would be confusing to most investors. In our view it is very difficult to lay out in an understandable manner (see our comments in Question #11 above) and we would appreciate the opportunity to discuss this with the CSA before the national instrument is finalized.

Some specific comments with respect to the proposed disclosure are:

a) We do not believe that disclosure to the individual client level is meaningful. In our view disclosure for the adviser in total is sufficient; in the belief that when an investor selects an adviser they are interested primarily in how the business is run overall and whether the adviser will manage the money effectively. Please also refer to our comments below for question #14.

b) Disclosure by name of the dealers and suppliers utilized by the adviser violates business confidentiality by forcing the disclosure of potentially competitive data. Providing a general description of the goods and services received would be sufficient for most investors.

c) Breaking out the commissions by security class does not provide meaningful information to the investor. We believe that the investor focus is on total costs.

d) Similar to (b), we do not believe that the provision of the weighted average cost per unit of security class is meaningful to the average investor. If the focus is on total costs then the ratio of the total cost of client commissions to assets under management is more easily understood and aligns with the determination of the Management Expense Ratio or MER. As mentioned previously, such disclosure would also be consistent with what is required of investment funds under NI 81-106.

e) The requirement to distinguish between bundled and unbundled services does not provide a meaningful distinction in our view. We believe that it is inappropriate to require a greater level of disclosure with respect to goods and services obtained from third parties, where a further breakdown is proposed, than for bundled services. What is received is what is important, not whether it is received as part of a package or independently. For example, research is part of both categories. Segregating the source or how it is received is not meaningful for an investor, only the fact that research was purchased is important. Consequently we recommend that this distinction be removed and that the only breakdown be between order execution and research, with the latter broken down between what is retained by the executing broker and what is paid to third parties. This would be consistent with the categories in the instrument, and is consistent with the recommendations developed in the United Kingdom by the Investment Management Association and the National Association of Pension Funds.

Question 13:

Should periodic disclosure be required on a more frequent basis than annually?

We believe that annual disclosure is sufficient for investors.

Question 14:

What difficulties, if any, would an adviser face in making the disclosure under Part 4 of the Proposed Instrument?

The main difficulty with the proposed disclosure is the requirement to allocate the commission dollar analysis to the level of the individual client. There would only be rare instances where commissions and their usage could be tracked to a specific client. We believe that, given how the trading activity is conducted by most of our members at an aggregate level for multiple clients at once, providing data to the individual client level would

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become a large and burdensome cost allocation exercise, driven by whatever assumptions and allocation methodologies that the adviser considers reasonable. Any such allocation processes would likely require development by the adviser in-house, increasing costs significantly to develop and maintain. These costs would ultimately be borne by the investor. Given the range of businesses and allocation methodologies employed in the business world any such result is only a "best guess". In our opinion investors would perceive the level of accuracy to be greater than is actually the case.

We believe that disclosure at the adviser level of the totals involved provides sufficient information to investors so that they can understand how the adviser uses commissions and that they are being used for the benefit of investors, which are two of the stated goals of the initiative.

We also submit that the proposed requirement to disclose the specific suppliers of such goods and services would violate accepted norms of business confidentiality by forcing the disclosure of proprietary information. The vetting and development of supplier relationships can be a large part of an adviser's competitive advantage. Disclosure of such detail places the adviser at a competitive disadvantage, particularly with respect to foreign competition that does not have a comparable disclosure requirement.

In addition to the proposed disclosure, we believe that the specific books and records requirements are onerous and of questionable benefit. The requirements have the potential to necessitate the creation of a tracking and documentation system, especially with respect to items that are obtained other than through invoices or through more informal processes. In our opinion the general requirement on all advisers to maintain adequate books and records to support the business is sufficient. The proposed national instrument does not have to contain additional requirements.

Question 15:

Should there be specific disclosure for trades done on a "net" basis? If so, should the disclosure be limited to the percentage of total trading conducted on this basis (similar to the IMA's approach)? Alternatively, should the transaction fees embedded in the price be allocated to the disclosure categories set out in sub-section 4.1(c) of the Proposed Instrument, to the extent they can be reasonably estimated?

We define trades done on a "net" basis to be trades done with no commission paid where the broker is remunerated by the bid/ask spread, or trades done on a principal basis.

In our opinion such trades should be disclosed in a fashion similar to the UK IMA's approach. If transaction fees can be reasonably estimated (see our response to question #1) then they should be allocated. Disclosure is the first step to measurement.

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