Kenmar
The Fund OBSERVER

August 15, 2006

Ontario Securities Commission
c/o John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
Suite 1903, Box 55
Toronto, Ontario M5H 3S8
Fax: (416) 593-2318
Email: jstevenson@osc.gov.on.ca

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
Email: consultation-en-cours@lautorite.com

Dear Mr. Stevenson and Ms. Beaudoin:

PROPOSED NATIONAL INSTRUMENT 23-102 USE OF CLIENT BROKERAGE COMMISSIONS AS PAYMENT FOR ORDER EXECUTION SERVICES OR RESEARCH ("SOFT DOLLAR" ARRANGEMENTS)

Kenmar welcomes the opportunity to comment on these proposals. By way of introduction, Kenmar is an Ontario based organization focused on mutual fund investor education via on-line papers hosted at www.canadianfundwatch.com.
Kenmar also publishes ***the Fund OBSERVER*** on a bi-monthly basis discussing investor protection issues primarily for mutual fund investors. A subsidiary, Portfolio Analytics, assists investors and/or their counsel in filing investor restitution claims.

In our view, the *primary* purpose of securities regulations and regulators is to protect investors. It is in this context that we examine NI23-102 with a focus limited to actively- managed mutual funds sold to retail investors. The same principles however, apply to Segregated funds, LSIF's, Index funds, ETF's and even to hedge funds. Hedge funds were the main benefactors in the market timing scandal as they used investments, brokerage commissions and cash to induce fund companies to allow market timing and frequent trading. Hedge funds are a major and growing source of trading activity on North American exchanges. They remain loosely regulated and have recently come under fire for shady practices such as shorting stocks for which they have influenced negative research reports. The role, if any, of soft dollars is unclear at this point. Additionally, Principal Protected Notes and other structured products appear to fall under the radar of regulators and are a growing concern for small investors.

Some 10 million Canadians entrust their savings to mutual funds as the backbone of their retirement nest eggs. Canadian mutual fund assets are approximately $600 billion spread among about 5000 funds of various types and classes.

In a very real sense, mutual funds and other investment funds are the dominant traders on the TSX and the Venture exchange

A. Preamble -An investors perspective

Soft dollar trading has long been high on the list of investor concerns. Soft dollars are among the "least visible" and "least understood" opaque expenses for investors. Whenever huge conflicts-of interest meet huge sums of money, big problems can arise. This is especially true in Canada’s financial services oligopoly. Investment bank research, since it is clearly influenced by top management and logical self-interest to promote higher investment banking fees is regarded as suspect. Independent third party research is viewed as more objective and so is highly valued by investors and consumer groups. However, the soft-dollar system is regarded as an inappropriate method of acquisition after all the broker and fund company scandals and potential conflicts-of interest. Retail investors have lost trust and cannot support a policy that invites malfeasance, is difficult to measure and resistant to robust enforcement. This current request for comments represents a wonderful opportunity for the CSA to take an international lead in investor protection for the 21st century.

When investment firms use soft dollars, they pass the expense on to investors through brokerage commissions that traditionally have not been transparently reported. They get buried in obscure filings and aggregated with multiple funds in the firm's family. This makes it extremely difficult, even for the most savvy investors, to ascertain exactly what price or benefit they are obtaining. In a real sense, soft dollar trading is related to property rights.

Clean, pure trade execution is especially important for mutual funds, that due to their nature, deal with large numbers of shares (and dollars) per transaction and in aggregate. There is a tradeoff between favouring long-term investors (e.g. equity mutual funds) and short-term traders by requiring markets to privilege price over speed of execution. Sometimes, the trades are through - parties since some fund companies are part of organizations that also own brokerage firms e.g. all the Canadian banks. For tax reasons, trading commission costs do not form part of the MER calculation but they are a cost, often significant, that the fund (the retail investor) incurs. The CSA has recognized this by requiring the disclosure of the Trading Expense Ratio. Commissions dollars paid are generally reported in the Annual financial statements of each fund, usually in the NOTES section, giving them no context.

Generally, “soft dollars” are considered to be brokerage commissions which are used to pay for products and/or services not directly related to basic order (trade) execution. “Soft dollars” is thus a term used to describe a situation where a mutual fund places trade execution orders in exchange for other services such as research reports. [but it could be (mis) used to mask other services and rebates]. Per NI23-102, order execution services may also include such elemental services as trading advice, custody, clearing and settlement services that are directly related to an executed order that generated commissions, algorithmic trading software and even raw market data, to the extent they assist in the execution of orders. We simply cannot comprehend how a contemporary mutual fund company that holds out a shingle claiming “professional management ” would not have these basic capabilities as core competencies. Correspondently, we would expect that a modern brokerage catering to the mutual fund industry makes such order execution services available in the ordinary course of business. Soft dollars give mutual fund companies an unhealthy incentive to unduly pay for primary services or marketing advantage with soft dollars.

Generally, as we understand it, the soft dollar arrangement is not well documented and even if properly documented is virtually invisible to investors. Soft dollar supporters point out that if soft dollar trading is banned, fund MER’s will rise even above their already lofty levels. Some small fund firms state that without soft dollars trading they could not economically access investment research and maintain current MER levels. Ironically, since the average turnover of equity mutual funds is about 100 %, the logic for comprehensive fundamental research appears weak as most funds appear to be short-term traders. Soft dollar supporters also argue that the cost is indirectly reflected in publicly disclosed return performance data so why should investors care about the details.

Opponents point out that Soft dollars can lead to higher fund costs and excessive portfolio turnover. It is possible that some funds even subsidize others through soft dollar transactions. Beyond the numbers, soft dollars trading is not a practice consistent with an ethical fund company culture and can unnecessarily lead to serious proper business conduct issues and conflicts- of- interest. It is our conviction, as stated in our previous submission, that a complete prohibition of soft dollar transactions will provide a greater good to a large stakeholder base and hence is in the public interest.

Among pension funds, it has generally been agreed that soft dollars trading is not a best practice and it may have hurt fund performance.
"That (soft dollars) is a no-no here. And I would say that should be an absolute no-no for anybody, because that's so rife with conflict- of- interest it shouldn't even be touched with a 10-foot pole."

- Bob Bertram, executive vice-president of investments with the $76-billion Ontario Teachers Pension Plan fund

Source: Sinclair Stewart, “ Outcry over 'soft dollars' sparks new hard line: Enduring practice in the crosshairs ”, Globe and Mail, April 5, 2004 - Page B1

Even fund companies have expressed, concern:

“I honestly think that soft dollars will not be able to stand the test of time this time around ”

-Bill Holland, CEO, CI Fund Management Inc.
Source: W. Dabrowski, Financial Post, July 21, 2004 Pg. FP1

We also point out that Fidelity, the world's second largest fund Company, is moving away from soft dollars. Respected fund firm, Vanguard Funds, a successful low- cost U.S. fund company purports that it has never used soft dollars. After the huge 2004-2005 market timing settlements MFS/ Sun Life claimed they would prohibit the use of soft dollar transactions. Domini, the largest U.S. SRI fund Company does not use soft dollars, and we add parenthetically it has had no difficulty attracting clients, competing or delivering solid performance. In Canada, we have confirmed that Meritas Mutual Funds, in their approach to Socially Responsible Investing, do not use and do not find it necessary to use, soft dollar commissions.

B. What's happened in the U.S.?

In testimony March 23, 2004 to the U.S. Senate Banking Committee, Robert Pozen, the new Sun Life/MFS Chairman asked for the SEC to return to severe restrictions on soft dollar transactions that existed before 1986. He wants the "addiction to extra charges" to end. In 1986 they were permitted only if a service "was not readily available for cash". Then deregulatory chairman, John S.R. Shad, lifted restrictions on how funds could use soft dollars that opened the door to abuses, such as brokers paying fund advisers' rent and cable-TV bills.

Several U.S. firms employ a benchmark for measuring trading efficiency known as volume-weighted average price, or VWAP. The measure compares an individual trade against the average prices paid for that stock on that day, with bigger trades weighted more heavily. Using VWAP metrics, fund companies have channeled more and more business to the most skillful brokers. On in-house accounts, fund companies have tied their trader's bonuses partly to performance measured by VWAP, shaking up the old system of awarding bonuses largely based on the subjective opinions of portfolio managers. Fund performance has increased as a result of the reduced commission costs.

Recent SEC changes (and in Australia) have further clamped down on soft dollars as a result of continuing concerns with the practice. The SEC has chosen to act with a light touch perhaps because some market participants have taken the lead in dismantling the soft dollar apparatus. In November, 2005, it was reported that mutual fund giant Fidelity had reached an agreement with Lehman Brothers to unbundle research and trade executions. Fidelity now pays Lehman an estimated $7 million a year for its research and $0.02-$0.025 cents USD per share in commissions (the industry average at the time was $0.036 cents per share). Since then, Fidelity has put in place similar arrangements with Deutsche Bank and Thomas Weisel.

Soft dollars "applications" continue to raise U.S. eyebrows. A 2005 U.S. report cites the Lionel Amron case. Amron is suing the folks who run Morgan Stanley S&P 500 Index fund, claiming that they are "grossly overcompensated" by the fees they earn from this fund. The fund carries a 1.50% expense ratio for the "B" shares of this index fund. He claims that more than 71% of the brokerage commissions of Morgan Stanley

S&P 500 Index fund were used as soft-dollar payments to purchase third-party "research”. Inasmuch as an index fund has no conceivable need for "research," and assuming that Amron's allegation is true, the managers of this fund were almost certainly enriching themselves at the expense of their shareholders. Apparently the SEC was unable to detect the alleged wrongdoing. We remain concerned that Canadian provincial regulators with even less resources will be unable to monitor and enforce compliance with NI23-102.

C. Soft Dollars - a troubling practice

Listed below are the main concerns retail investors have:

1. Soft dollar transactions, not untypically, have less than pristine documentation. trail. They are a masked expense that has the potential for skimming. There is no practical way to distinguish whether services acquired via soft dollars were already budgeted within the management fee. <u>We are not aware of any accepted study or system that quantifies the excess benefits of soft dollars vs. direct procurement of services</u>. We remain constructively critical that Mixed –use services cost allocations will be fairly distributed among the firm’s products and offerings. And we remain convinced that any discrepancy will not be able to be judged because of the qualitative nature of the process i.e. not enforceable. .
2. Can lead to hard-to detect abuses and unfair and indeterminable allocation of benefits to select mutual funds or other portfolio pools. <u>Therefore, soft dollar transactions should be formally identified and disclosed in the Prospectus as an explicit risk of investing in mutual funds</u>, if, despite our reservations, soft dollar transactions are maintained.
3. Potentially increases fund costs that investors pay. We believe a diversion of energy to relentlessly bring down brokerage commissions will have a greater positive effect for investors than the resources expended today in utilizing, administering, monitoring, storing (for 5 years) and debating soft dollar transactions
4. May be breaching Income Tax Act by avoiding GST-could be considered a barter transaction. Perhaps more important is that a period expense, research, is being capitalized. This can, in effect, unduly affect income taxes properly payable. In effect the same cost element, research, is being treated in 2 different ways on the same financial statements. We do not understand how the CICA and CRA are comfortable with this arrangement.
5. It's simply bad accounting -it doesn't match costs to revenue (benefit) and securities research should be expensed not capitalized as part of the portfolio expenses.
6. Fund managers should be striving to obtain the lowest, responsive, responsible broker commissions and disclose that they did so. Those brokers who come through should be rewarded with more business as part of a continuous improvement program.
7. Research is now more readily available from multiple sources; some “independent research ” in the past may in fact have been tainted e.g. Nortel, Bre-X, Hollinger. Low- cost independent research is available offshore now from, say India- based analysts, that appear to be of comparable quality to that of Bay Street.

8. Limited audit trail and quantitative measurement tools exist to validate that the practice has a net positive cost-benefit for fund investors
9. Brokerage commissions, as mutual funds assets, should not be used to potentially line fund sponsor pockets, give the appearance of doing so or incur extra costs for ensuring that they do not do so. We do however like the temporal test being proposed.
10. Trustees, IRC members and Directors with fiduciary obligations cannot readily monitor these transactions for compliance leaving them exposed to litigation.
11. Can lead to higher portfolio turnover than necessary, adding to increased fund expenses, lower fund returns and increased taxable capital gains exposure for investors. An example cited by one respected fund analyst cites the case where a dealer could over commit on its soft dollar arrangements. This could cause conflicts if it traded accounts that did not benefit from the specific service paid for from its commissions or cut off dealers who would otherwise supply useful investment intelligence to the organization.
12. When executing international market trades, such commissions could be used as a form of money laundering as has been reported by Homeland Security in the U.S. This causes us to suggest limiting any soft dollars to Canadian or U.S. –based brokers.

Basic common sense argues that someone paying cash for a service directly is likely to be a lot more hard- nosed in his negotiating than someone using commission dollars, which don't impact the fund Company bottom line. It’s also entirely possible that some services are valued/priced higher in soft dollars, which isn’t good news for investors. A gruesome scenario of a soft dollar trade is presented in Attachment II.

We are skeptical regarding soft dollar benefits and feel the Wharton School paper [Attachment IV Reference (3)] is on the mark.

D. Putting some numbers on soft dollars

According to research firm Greenwich Associates (www.greenwich.com) in 2002, U.S. mutual funds and other institutional investors paid about $12.7 billion in commissions, and about $4.5 billion (35.4 %) of that went toward research and other items purchased with soft dollars. Source: Summary of May 5, 2003 report “U.S. Equity Soft-Dollar Practices — U.S. Investors”

Using Greenwich's numbers and estimates that put total U.S. fund expense payments at $70 billion a year, adding soft dollars to expense ratios would cause the <u>average</u> to rise by 6 %. For funds that trade stocks most rapidly, however, the disclosed expenses could more than double. Soft dollar transactions abuse investors in that the true cost breakdown of operating the fund is not disclosed, costs are incurred for activities of unknown or questionable benefit to the fund and potentially excessive costs are incurred due to higher brokerage fees /higher portfolio turnover rates.

The July, 2000 OSC ‘s *Final Report Mutual Fund Governance Cost-Benefit Analysis* (Section VI) authored by Keith A. Martin stated “…In Canada, it is estimated that a soft dollar transaction costs **<u>$0.06 per share compared with $0.03 per share for trades where soft dollar arrangements are not a factor</u>**…". Effectively, a mutual fund pays twice the normal costs for trading when soft dollars are permitted. Quantifying the benefits of doing this are elusive. Cynics believe that these extra costs may in fact simply be increasing fund company profits with minimal benefit to unitholders.

Soft dollar trading is a major issue in Canada with some estimates putting it as high as 25 % .An estimate by Investment Executive's Jean Murphy put the total value of brokerage commissions paid in 2002 by all equity-based funds — balanced, Canadian, U.S. and international - at $513.2 million, a 2.3% increase from the $501.6 million paid in 2001 but unchanged from the 2000 market peak. No doubt the figures are much larger now. It's easy to see why money-management firms are reluctant to get off this gravy train.

E. Responses to 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? **Anything that cannot be monitored or measured should be out of bounds –OTC markets fit that description. In any event, soft dollar transactions need to be periodically monitored and policies reviewed and approved. We note parenthetically that we are concerned that the extra costs for monitoring, auditing, documentation and disclosure involved will result in little or no net benefit to unit holders, perhaps even reduce returns.**

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? **As we have pointed out, we believe that the additional costs of monitoring cost reasonableness detracts from investor returns. In any event, <u>index funds and index ETF's should be outright prohibited from using soft dollars.</u> We also feel that bond ratings, basic bond data along with elemental analysis provide adequate visibility in most cases for those funds investing in bonds. Tracking in a dealer market that does not have pre- or post trade transparency such as the debt or unlisted equity market would be very difficult, if not impossible, in our view. If eligible products or services, such as independent research reports, are acquired to camouflage the payment to broker-dealers for ineligible services, obviously regulators, auditors, compliance staff and investors could not determine reasonability. We are concerned that elaborate systems and corresponding overheads will be needed for reasonability assessments, which in the end will be at the expense of unitholders.**

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”. **Our general comment is that *tools of the trade,* the basic hardware, software, reports, comm links and other resources needed to competitively and compliantly run a contemporary mutual fund should not be considered *order execution services*. The costs for these tools should be integral to the management fee. Other expenses, if material, should be isolable line items on financial statements and dealt with in the NOTES.**

Question 4:
Should post-trade analytics be considered order execution services? If so, why? **No- we note again such analysis should be an integral part of an investment Company’s core business. It should be part of the management fee as a cost of dong business. It would be one of the industry’s most dramatic ironies if fund managers were to pay inflated commissions in return for trading cost measurement services which invariably tell them that their brokers cost too much!**

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.? **Canadian mutual fund investors purchasing U.S.- based mutual funds face less difficulties and concerns because SEC regulations are now more stringent and enforced. They also benefit from much lower MER’s and knowing basic fund governance is the law. Market participants however might be negatively impacted but if the focus is on investor protection, the required policy decision is clear.**

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? **The dictionary defines <u>research</u> as *studious inquiry or examination; especially: investigation or experimentation aimed at the discovery and interpretation of facts, revision of accepted theories or laws in the light of new facts, or practical application of such new or revised theories or laws*. So raw market data doesn’t qualify. The very fact there are so many questions as to what constitutes research should give pause as to why soft dollars are being permitted. Rest assured, if soft dollars are permitted, industry participants will find cunning and creative ways to justify anything they wish, as they have done so successfully in the past.**

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? **Fund companies should pay for trading and break out other expense categories such as proxy- voting services separately on financial statements, if material .The management fee is supposed to pay fund managers for being professional shareholders of the securities in the fund and to act responsibly. We wouldn’t want to see proxy-voting services included as *research* since it could stimulate undue, costly trading.**

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)? **We repeat, all this accounting and cost allocation effort detracts from the basic purpose, managing money at the lowest possible cost. No doubt, after the first scandal occurs, fund auditors will have to audit the process, adding further expenses (and reducing investor returns)**. **Some of the ideas proposed by RBC Funds in Attachment I may be useful as a minimum benchmark if soft dollar trading is maintained in some form. It's a matter of documentation. monitoring and effective fund governance (as opposed to IRC Committees).**

Question 9:
Should mass-marketed or publicly-available information or publications be considered research? If so, what is the rationale? **Absolutely NO. If we're not careful nearly everything a manager is supposed to do will be funded via soft dollar commissions. We don't want to see a subscription to the Globe and Mail identified as research or a Journal that a professional should have as part of being a professional. If allowed, DYI investors could also make a case to the CRA for deducting these costs and a host of other everyday expenses as an expense, an undesirable situation.**

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? **It would be wise to include realistic examples of services and research that regulators consider improper.**

Question 11:
Should the form of disclosure be prescribed? If prescribed, which form would be most appropriate? **We would prefer regulators prescribe a standard format to ensure consistency, completeness and simplify analysis. Disclosure of bad practices is however not a solution. In fact, disclosure alone should not reduce investors' legal position in subsequent disputes or class actions.**

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? **Kenmar remains constructively critical regarding the use of soft dollars by retail mutual funds. We strongly believe in and support independent third –party research but do not agree it should be funded from brokerage commissions. Realize too that disclosure benefits not only investors, but would be used by fund analysts, academics, lawyers, economists, the media, law enforcement, regulators etc. Any disclosure should provide visibility on related-party soft dollar transactions, if these are permitted (unclear from NI23-**

102 language). We define our disclosure criteria in Section F (3) below. An additional measure that would be useful would be to provide average dollarized per-unit of security trading rates from efficient electronic trading systems as the *encumbered core commission rate* benchmark. This would provide at a glance, the premium being paid for soft dollar transactions. The *Statement of Portfolio Transactions* which was an invaluable analysis tool, should be reinstated as an on-request report. Many analysts and investors have lamented its sudden and unexpected demise.

Question 13:
Should periodic disclosure be required on a more frequent basis than annually? **Annual is adequate unless a special situation arises.**

Question 14:
What difficulties, if any, would an adviser face in making the disclosure under Part 4 of the Proposed Instrument? **We're not able to respond, but on a hypothetical basis the main difficulty will always be justifying the transaction and its value/benefit to unitholders.**

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? **Again, we do not believe disclosure will significantly help most retail investors. Kenmar believe the best solution is to purify mutual funds of all controversial business practices. The frequent trading scandal left lasting scars augmented by Norbourg and an assortment of hedge fund fiascos. At the very least, mutual fund managers should be required to disclose the amount of soft-dollar benefits they receive, item by item. For greater transparency, commission expenses should be disclosed in the Annual financial statements suitably annotated. <u>Soft dollars should not be permitted between related –parties; these should be purchased at market rates and funded by the management fee</u>. Fund managers shouldn't use soft dollars to buy anything that is "readily and customarily available and offered to the general public on a commercial basis" e.g. newspaper subscriptions, commercially available software, Quotation terminals, PC's/laptops, seminar fees, training courses and travel or entertainment costs etc. If fund managers need or want such materials, they should pay cash out of their own pockets, just like everyone else. Finally, managers should be required to spell out all soft-dollar arrangements in detail, in writing and have documented internal control and audit policies and procedures.**

Kenmar believe that the CSA should prohibit soft-dollar trades outright as a number of industry participants already claim to have done. <u>Independent third party research is very valuable but it should be acquired via a direct payment out of the management fee</u>. It's time for some of the historical questionable practices to be put to sleep. We concur with the CSA that (1) computer hardware and software, databases and any other electronic communications facilities, used in connection with trading (2) publications, including books, periodicals, journals, newspapers/newsmagazines and electronic publications, that are available to the general public on a commercial basis or free from Govt. information sources; (3) seminars and associated travel/ accommodation expenses, (4) compliance tracking and monitoring systems and (5) custodial arrangements, custodial record keeping services and transfer agent functions be excluded from the definition of "investment and decision-making services" .For greater certainty we would specifically prohibit any data/voice/video communication lines (whether open or dedicated) , internet fees , satellite links and the like. We would also prohibit any systems for fund governance or compliance to be acquired via soft dollars- the firm (fiduciary) should have to use its own cash to pay for these systems.

If a fund manager believes that access to certain research (or specialized software/databases, etc.) will result in superior investment returns, then he/she should by all means pay for it - this is precisely the type of expense that should be paid for out of the management fee.

F. Four Related Points

In addition to the material aspects of the services we would like to remark on three other aspects of proposed rule NI23-102. :

(1) The **Statement of Portfolio Transactions,** which was inexplicably dropped against our recommendation, as a result of the implementation of NI81-106 should be reinstated and made available on request to investors as before. This was an invaluable aid in assessing portfolio management trading activity. The format, content, font size and legibility should be prescribed and standardized by regulators so analysis can be readily effected.

(2) **Regulatory Exemptions** We continue to be highly skeptical of regulatory exemptions, as they appear to be back door opaque amendments to securities regulations. Para 5.1 effectively allows any part of NI 23-102 to be amended or waived without thorough public debate, often without investor knowledge or concurrence. In essence, this paragraph can, with the swish of a pen, negate years of investor advocacy. Exemptions increase both compliance and enforcement costs and ultimately the cost to investors .A 2002 study by Nebraska University law professor C. Steven Bradford, *The Cost of Regulatory Exemptions*, concluded that:

"..If we concede for the purpose of argument that the regulation is an efficient one—that is, application of the regulation generates greater benefits than its costs (or more accurately, the level of regulation generates the greatest net benefit possible)—then the only basis for exemptions is that, for the particular persons or transactions exempted, the cost-benefit condition does *not* hold. For the exempted persons and transactions, the costs of regulation (or, in the case of a partial exemption, the costs of full regulation), exceed the benefits…"

Investors can spend many man-years striving for the adoption of new investor protection laws, while the OSC Staff, with the signature of two Commissioners, can grant exemptive relief from any of these laws. Investors may not intervene before or after the exemptive relief decisions. Commissioners say they do not have any authority to give notice of these exemptive relief applications or to hold public hearings before such decisions are made. Investors may not communicate with the Commissioners making these exemptive relief decisions to determine the reasons for these decisions. The Commissioners are not obliged to publish any reasons except to the applicants, usually the mutual fund companies. While the final decision is posted on the regulators website it is not communicated to the public at large. A March, 2005 Kenmar Research Report [Exemptive *Order Relief-Good or bad for investors?* available at www.canadianfundwatch.com] found that such relief is more often than not, not in the best interests of retail fund investors. **As a result of these oppressive conditions, we'd like to see a specific prohibition of exemptive relief regarding this important Instrument.**

(3) **Disclosure Criteria** As regards enhanced disclosure, we have no choice but to accept it as an alternative to prohibition. But, disclosure, no matter how detailed does not make a questionable or unnecessary practice good. . We believe **the *Statement of Portfolio Transactions*** is an invaluable document in understanding fund trading activity and should be part of the disclosure package, but be available only upon request. Whatever disclosure is provided should (i) help investors determine the extent of soft dollar trading in $CDN, (ii) disclose the weighted average cost of trades, buy and sell, per unit of security in $ CDN cents and the unencumbered benchmark trading cost per unit of security for the current year and 4 years prior [this adds important perspective], (iii) understand the NET benefits achieved from the services and (iv) identify the recipients of the soft dollars. For those information elements [para. 4.1 (2)] available only on request, the fund prospectus and/or MRFP should contain a prominent NOTE advising of their availability and how to make the request. All disclosed information should be presented in a standardized format and be presented at least annually in a defined location(s) /Document, perhaps the AIF and/or MRFP.

The prospectus should also state (in Plain language) that a fund engages in soft dollar trading and that one of the defined risks is a conflict-of –interest as between the manager and the fund. Again, if non-compliance with disclosure regulations result in the same lack of accountability, enforcement or sanctions evidenced in the recent CSA Staff Notice on Income Trusts **51-319, Aug. 4, 2006** then we once question the usefulness of disclosure.

We are unclear if a manager must disclose soft dollar transactions if they are not asking for it, if they are not using it or are unaware it's bundled. It is our belief that the CSA should clarify this point.

"Are people on the adviser's side aware of whether they're using soft dollars or not? They probably think they aren't when they use the broker's research."- Christopher Van Slyke, Managing director of Capital Financial Advisors LLC of La Jolla, Calif. **[this is an important observation as regards this Instrument**]

Source: S. Hansard, *Advisers misreport use of soft dollars*, InvestmentNews.com, July 24, 2006

Record keeping should be sufficient to ensure that unitholders can (a) receive assurances that what the investment manager is doing with the client's brokerage can be supported in an "audit," and (b) receive important information on request.

(4) **Directed Brokerage** On August 4, 2006, the U.S. National Association of Securities Dealers fined 4 broker-dealers affiliated with ING America Insurance Holdings Inc. $7 million USD for taking brokerage commissions from mutual fund complexes in return for preferential treatment of their funds in violation of its Anti-Reciprocal Rule http://www.nasd.com/PressRoom/NewsReleases/2006NewsReleases/NASDW_017110. NASD found that from 2001 through 2003, the 4 broker-dealers, provided a host of marketing benefits to 10 mutual fund complexes that participated in the directed brokerage program, known as the *Strategic Partners Program (SPP)*. The Program went undetected by NASD/SEC and unreported by ING Compliance staff during the 3-year period. The benefits included yearly sales goals, special placement on the ING firms' intranet websites, direct links to the websites of the participating fund companies, participation in annual national meetings, waiver of ticket charges for registered representatives on sales of participants' funds, and other marketing opportunities. The benefits were designed to have brokers push preferred funds on a preferential basis.

In return, mutual funds paid the ING broker-dealers millions of dollars to participate in the *SPP*. Eight of the 10 participating mutual fund complexes paid a portion of their fees by directing approximately $25.7 million in mutual fund portfolio brokerage commissions to the four broker-dealers. Although similar protective rules exist in Canada, we cannot be assured that similar directed-brokerage transgressions are not occurring here. This is yet another reason we believe that a regulation that makes it clear that broker commissions are to be used for basic trade execution only is the cleanest, simplest, enforceable and ethical solution for investors and the financial services industry.

G. Summary and Conclusion

Alternative trading systems, enhanced, economical information systems and vastly improved technology are dramatically impacting the trading process for equities and bonds. This is a good time to rid ourselves of the unnecessary and controversial practice of soft dollar transactions in retail mutual funds.

The U.S. experience suggests that we would have to be continuously on the lookout for "stretched" ideas of what *investment decision-making services* can become. Canadian laws are somewhat different but limited regulatory oversight may have let bad practices creep in. In the United States these services have included PCs, Bloomberg terminals, satellite access, T1 datalinks, investment strategy seminars in exotic locales, dual- use services (can be used by specific fund, other funds in or outside the complex and the fund company itself), travel to companies for due diligence and lots more. We should learn from the experiences of others and tailor our policies to the needs of Canadian mutual fund investors .A retired Bay Street fund executive has labeled soft dollars *" A toxic mixture of tied selling, bundled pricing and wink & nod procurement "*. We cannot but note that tied selling in the banking industry is illegal.

Brokerage commissions are a cost to a fund- best execution is the most important factor and transparency is important. Prohibiting soft dollars would make it easier for investors to understand the costs of various investment advisory products and services. The commission dollar breakout/cents per share, the TER, the Turnover ratio and the Statement of Portfolio Transactions would provide reasonable trading visibility to investors and fund analysts. This weighs strongly in favor of abandoning soft dollar arrangements involving mutual fund assets. High Canadian MER's and other fees should provide more than enough cash to provide all the necessary research.

<u>Indeed, soft dollars could in fact result in double-dipping</u>. Such research is after all the raison d'etre of the portfolio manager. Under the proposed regime, costs may be allowable but they may in fact be costs the manager had budgeted within his management fee structure. There is no way to definitively know if double-dipping is or is not occurring. If there were a consistency provision, it might be possible to make some high level assertions but alas there is no requirement for consistency on the application of soft dollars. Application could in fact be random or spurious depending on the then current profit or other objectives of the manager.

Canadian fund companies disclose soft dollar trading activity and imply they are fully compliant (whatever that means) with regulations. They claim that the mutual fund industry is staffed with well-supervised and trained ethical people that investors should implicitly trust. Maybe so, but the recent mutual fund market timing, Norbourg and other scandals have made "trust me " difficult to swallow. A review of the IDA market timing settlement agreements indicates shocking behaviour and investor abuse on the part of 3 of Canada's leading brokerage houses. Imagine if fund auditors (or custodians or transfer agents) started a similar soft-dollar game for the extra services they could provide. A 2004 article by Whitney Tilson *The Disgrace of Soft Dollars* makes exactly this point. Source:
http://www.fool.com/news/commentary/2004/commentary040319WT.htm

We should remain mindful too that bank- owned mutual funds (and others like Dynamic, Caldwell and AIC) have huge affiliated brokerage businesses (profit centers), and that bank mergers, vertical integration and industry consolidation are likely to dramatically add to the scope, scale and perils of the conflicts –of- interests dilemma. <u>This small, closely- knit community of financial service providers makes the issue of soft dollars particularly acute in Canada as compared to the U.S. or the U.K.</u>

Is all this complexity, cost, regulation, administration, disclosure AND bad perceptions really worth it? Be done with the controversial practice, include all trading /research related activities in the management fee where it belongs, and move on. This would make the interests of fund managers and fund investors better aligned.

Any new policy on soft dollars has to either (1) permit bundled commissions for both independent research (as an exemption from new soft dollar restrictions) and in-house research (continuing current practice of bundled commissions); or, (2) force direct payment for both independent research and in-house research and specify the source of the funding to be from either the fund or the management company (the same source for both).

We prefer option (2) because it would allow mutual funds, consistent with best execution and liquidity requirements, to increase trade with discount brokers and electronic exchanges and thereby reduce shareholder trading costs. Eliminating the potential conflicts- of- interest will strengthen the operating integrity of mutual funds

"…Why do you all have to do it? Before, research was done to get underwriting. Now, you can't use it to get underwriting. It's become more like a commodity…"
-Glenn Cooper, eResearch (www.ersearch.ca)
Source: Hanley W., "The Home Depot of equity research ", FP MONEY, Aug. 28, 2004

Attachment III from Abel/Noser [http://www.abelnoser.com/] offers some additional insights on the topic as related to investment funds. N.Y. based Abel/Noser has long been involved in the campaign to lower the costs associated with trading. They provide a range of effective but not necessarily inexpensive tools and services for institutional sponsors and investment managers. Abel/Noser provides Transaction Cost Analysis in conjunction with other services that assist portfolio managers achieve significant cost savings. Their experiences are of value in the context of the current discussion.

Attachment IV provides additional reading references on this important topic.

In National Instrument NI81-107 *Independent Review Committee for Mutual Funds*, the CSA is suggesting that "soft dollar" transactions he regulated as a business conflict- of interest matter by a mutual fund's Independent Review Committee. NI81-107 has been critiqued by SIPA, CARP, fund analysts, personal finance journalists and even a former OSC Commissioner as providing a wholly inadequate level of investor protection. We would certainly be concerned about any attempt to use IRC's as adjudicators in such a complex area. We assume that IRC decision errors that cause harm to unitholders will not be protected under any indemnification or Safe Harbour under the provisions of NI23-102.

Of course, it doesn't matter what laws or regulations are in place, without continuous and diligent regulatory monitoring, enforcement and stiff penalties, history shows that anything can happen where so much money is involved. If and only if, wrist-slap penalties are avoided in future, exemptive relief is NIL or rare and enforcement probes are diligently pursued to conclusion, then all the effort in making more rules may be worth the effort.

We sincerely hope that the information and perspective presented herein will be of use to you. Should you require any additional information, do not hesitate to contact us.

Respectfully,

Ken Kivenko P.Eng.
President, Kenmar
kenkiv@sympatico.ca
(416)-244-5803

Attachment I –RBC's stance

As part of a package of reforms to restore unitholder confidence, RBC Funds made the following announcement in July, 2004 regarding tightened soft dollar policies:

"> We use soft dollars only for pure research services, a standard that is more restrictive than the Soft Dollar Standards recommended by the CFA Institute.
> We are committed to ensuring that commissions used for research are spent in the best interests of Fund unitholders.
> Soft dollars represent a very modest amount of our overall trading commissions. The annual soft dollar budget is reviewed and approved by our Chief Investment Officer and Chief Financial Officer.
> We monitor our trade executions to ensure all commissions, including soft dollar arrangements, are at competitive levels and satisfy our requirements to seek the best execution for all trades.
> Soft dollar policies are reviewed by the Audit Committee of the independent Board of Governors for the Funds.
> We believe that soft dollar commissions for research are, at present, important to maintain a level playing field between integrated institutional brokers (that provide "bundled" research and trade execution services) and the suppliers of independent research who rely on soft dollar commissions to support their business model. We believe the promotion of high quality, independent research remains an important policy objective of regulators.
> We are committed to increasing the transparency and understanding of the soft dollar issue. Source: Update on Mutual fund industry Issues from RBC Asset Management (RBC AM), July 2004 http://www.rbcfunds.com/pdf/industry_issues.pdf

Per the July, 2004 RBC Funds AIF, the following companies provided investment decision-making services during the prior year in the nature of research, statistical and similar services to RBC AM in return for the allocation by RBC AM of portfolio transactions: Banc of America; Merrill Lynch, Thomas Weisel; Canaccord Capital; Wachovia Securities; Commission Direct Inc.; Scotia Capital Inc.; TD Securities Inc.; CIBC World Markets Inc.; UBS Warburg Inc.; The Bear Stearns Co. Inc; SG Cowan Securities Inc., Fano Securities, E*Trade (TIR) HK, William O'Neil & Co. Incorporated, Catalyst Research Corporation and Veritas Research Corporation. **Quite a soft dollar supplier list and a lot of records to keep and actions to justify.**

Attachment II -The real world soft dollar trading process

A January, 2003 article *You only pay twice: Soft-dollar deals between brokers and fund managers are under fire south of the border. Why not here?* by Doug Steiner at globeadvisor.com [ADVISOR FOCUS] makes the issues abundantly clear. We quote directly---

"Let's walk through a best execution dilemma. Your portfolio manager, David, gets a hankering to buy Cogeco Cable, an illiquid stock you need a searchlight to trade. He wants 1.2 million shares. Cogeco Cable normally trades about 30,000 shares a day. The idea came from Tiny, Little and Insignificant, an investment boutique run by a couple of ex-$2-million-dollar-a-year research analysts who set up their own shop. David wants to pay them a commission of four cents per share--high, but not outrageous. That's $48,000 for the trade.

But David is also aware that Tiny, Little and Insignificant will butcher the trade. The trading desk is too small to get calls answered, and a badly executed order will lift Cogeco Cable by, say, $4 per share. Griffiths McBurney & Partners is the big-volume trader in Cogeco, but David is still mad at them because he got a lousy allocation on a hot IPO a few months ago. There goes best execution. Instead, David gives a less-hard-to-butcher trade to Tiny, Little: buying a million shares of Nortel, which an eight-month-old baby bashing an order entry keyboard couldn't screw up because the stock is so liquid.

David decides to do a soft-dollar trade with the Cogeco order because his boss is on his back to pay some bills. David gives the trade to a bank-owned dealer. The dealer takes the trade at five cents a share, and agrees to pay some of the fund company's bills with four out of every five cents. The remaining penny a share is fine because the dealer assumes that the seller with whom he matches the trade will pay the full freight.
This helps David. His firm saves money. The five-cent commission is included in the share price, which ultimately lowers returns to unitholders. But it's not included in the fund's management expense ratio (MER), the cost figures that investors look at.

The dealer turns around and pays, say, $1,200 for risk measurement services and $3,050 to another research firm for analyzing bank credit. It cuts a $6,000 cheque to someone to analyze risk. It sends $2,200 to pay for the fund's newspapers for the year. A saleslady picks up an $8,500 cheque for the fund's quote machine. And so on, and so on. The money's not all spent, so the dealer "banks" the balance, awaiting phone calls from the fund company to pay more bills. This is all legal if it's done for the benefit of unitholders. The amount paid in soft dollars is not reported. Investment companies will argue that soft dollars help keep MERs down, but who's kidding whom? Fees generally go one way in this business--up, up, up…" Source: www.globeadvisor.com

Attachment III Abel /Noser response to SEC Mutual Fund Transaction Costs

Abel/Noser
Member, NYSE and SIPC

Eugene A. Noser, Jr.
President
Abel/Noser Corp.
90 Broad Street
New York, NY 10004

February 23, 2004

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, D.C. 20549-0609

Re: Concept Release: Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs; File No. S7-29-03

Dear Mr. Katz:

Abel/Noser Corp., a member of the New York Stock Exchange and other leading exchanges, has long been respected as a leader in the campaign to lower the costs associated with trading. To that end, we provide a range of effective tools and services for institutional sponsors and investment managers. Abel/Noser provides Transaction Cost Analysis in conjunction with other services that help our clients achieve savings.

Abel/Noser Corp. provides Trade Cost Analysis services to over 400 institutional investors, including many of the largest mutual fund companies in the world. We evaluate over $4 trillion of institutional trading data annually. Our universe of institutional trading statistics includes information from over 500 separate investment advisors representing over 750 portfolio manager managers, including some of the largest global money managers. Using a combination of strike price and volume weighted average price measures we have developed investment style trading cost benchmarks that allow institutional plan sponsors and mutual fund directors to make relevant cost comparisons between investment advisors. We welcome the opportunity to comment on proposals to publish trading cost information in mutual fund disclosure documents.

Commissions Matter

Every officer of a defined benefit plan or mutual fund has an obligation to ensure that all actions taken by the plan are in the best interest of the beneficiaries. Our plan sponsor clients first concern is to ensure that their investment managers make hard-nosed decisions regarding the disposal of plan beneficiaries' commissions. To that end, they monitor explicit commission expenses by market and compare them to benchmarks derived from our universe. This enables plan sponsors to ask their managers meaningful questions when results deviate significantly from expectations.

Mutual fund investors should be able to look at similar statistics for the funds where they invest. Each quarter, a fund could publish total commission expenses by exchange in dollars, cents per share and basis points. The funds could also state these costs as a percentage of assets under management on an average basis. This latter statistic would sum up turnover as an input to commission costs.

The section 28(e) safe-harbor enables investment advisors to acquire independent investment analysis through the use of "soft-dollars." Soft-dollar practices are not in and of themselves wrong, but they are subject to abuse by corrupt practitioners. Many of our clients demand that their investment advisors provide them with information regarding the uses of commission payments that exceed "execution-only" rates, that is, the rate that would pay for trade execution alone. Execution-only rates are easy to determine, they are rates that ECNs like Island, Archipelago, and Instinet offer for access to electronic markets.

The commission should also require that Mutual funds disclose the commission payments in dollars, cents per share and basis points for different types of commission payments. These types of payments should include, proprietary research, independent research, sales of fund shares by the brokerage, and services such as market data or statistical services. Furthermore, fund advisors should disclose the extent to which they fund investment operations out of advisory fees.

Transaction Costs Matter, Too

The conversation becomes more recondite when our clients turn their attention to implicit transaction costs. We usually provide pension sponsors with results of three measures: the market opening price, the daily volume weighted average price and a volume weighted average price for a five-day time period centered on trade-day. Our mutual fund clients also use combinations of strike prices and volume weighted average prices to evaluate trades that extend over more than one day.

Strike Prices

Strike prices are prices that represent the prevailing market price at a specific instant. The strike price reveals the direction of the prevailing market trend during the time the manager executes a trade. Strike price measurement results are influenced largely by the mechanical workings of the market. Strike price measures reveal mechanical characteristics of the measurement method.

The open price serves as a reasonably useful proxy for the price that might have prevailed when the investment advisor decided to enter an order to trade. The difference between the open and the actual execution price represents a gain or loss enjoyed by the investor. The result versus the open price reveals information about the market conditions under which investment advisors complete their trades. Investors who prefer to buy rising stocks and sell falling stocks will incur higher costs than investment advisors who do the reverse. Neither strategy can be proven to offer an advantage to investors.

Spread Costs

Published spreads fluctuate constantly. Published spreads offer only a hint of available liquidity at given prices. Market participants seldom publish their trade intentions to trade to the world. Often, traders can submit bids or offers, provide liquidity, and capture the theoretical spread as a trading profit. Funds might publish an average spread for the stocks they trade, but we do not know of a generally accepted source of such information.

Volume Weighted Average Price

The daily volume weighted average price measure reveals a manager's ability to achieve reasonable executions compared to other simultaneous investors. We believe this measure offers a useful indication of a manager's ability to achieve "best execution." The difference between the trader's execution price and the volume weighted average price removes the market movement from the trading cost calculation. Many practitioners accept that volume weighted average price measures provide insight into execution quality. We suggest that volume weighted average price measurement results can be used as a reasonable estimate of spread costs. Documents could express costs in dollars, cents per share, basis points, and as a percentage of assets under management.

Unfortunately, the volume weighted average price measure is unpopular with many investment advisors because of a perception that their traders will fail to execute unfavorable trades in an attempt to "game" the measure. This argument assumes that traders will sabotage an investment idea in the pursuit of a better trade measurement result. Our experience tells us that no trader could play these games for very long. We believe that one can level the same "gaming" criticism at any measurement scheme that relies on reference prices that traders can deduce at the time of the trade. But these reference prices provide the most meaningful information about an investor's ability to implement their strategies and compete with other investors.

Opportunity Cost

Opportunity cost is defined as "the road not taken" in investment. An order that the manager does not fulfill to his satisfaction contains an element of opportunity cost: the gain that the investor had to forgo by failing to achieve an ideal investment. One could calculate opportunity cost as the subsequent performance of shares not bought. Several problems arise in capturing the data Portfolio managers may not reveal orders in a way that the firm can record. Portfolio managers with competing orders in the same fund family may enter larger orders than they require with some expectation that they won't get all the shares they request. Little mention is made of losses avoided, or the performance of dollars put to work elsewhere, but these would have to be taken into account in an accurate opportunity cost computation.

Trade Effect

The trade effect measure discussed in the concept release relies on strike prices after the trade to evaluate trading effectiveness. Like pre-trade strike prices, measurement results will overwhelmingly depend on market movement beyond the scope of the trader's skills. Little information is offered by looking at trades one or two days hence. An alternative trade effect measure would compare the active portfolio performance to the performance of the original portfolio held at the beginning of the measurement period. This would illustrate the effect of decisions to buy and sell securities versus a simple "buy and hold" strategy. We believe this simple analysis could be accomplished with fewer burdens on the investment manager and is easier for the investor to understand.

Conclusion

No single measure can reveal all the issues that surround the notion of "trading costs." However, we believe that the measure mentioned above, which reveals performance versus the investment advisors' original static portfolio, captures most of the value of decisions to buy and sell securities over the investment period.

Managers will find it very difficult to estimate trading costs. They will also face the inevitable conflict that will result from wanting to appear to minimize those costs in disclosure documents. Investment managers would have to adopt a uniform set of data acquisition techniques in order to provide the level of specific trade cost data that this concept release contemplates. Stringent data acquisition requirements could be onerous to small investment advisors, putting them at a disadvantage to large investment advisors. Also, uniform transaction cost reporting requires a universally accepted methodology for measuring costs. So far, this methodology does not exist in practice.

We thank the commission for the opportunity to comment on the proposed rules and hope you find our comments useful. If you would like to learn more about our experience providing transaction cost analysis to institutions, please contact me at 212-344-2610.

Sincerely,

Eugene A. Noser, Jr.
President

Attachment IV Some Applicable References

(1) A July, 2004 report "*Best Practices and Practical Guidance for Mutual Fund Directors*", by the Mutual Fund Directors Forum www.mfdf.com, done at the request of SEC Chairman William H. Donaldson, recommended a ban on soft-dollar commissions, citing potential conflicts-of-interest between the adviser and the fund. The Washington based Forum, a non-profit organization of U.S. fund directors unaffiliated with their funds' advisers, said one estimate put the soft-dollar market for investment research and related services at more than $1 billion USD. Soft-dollar arrangements raise questions, the report said. Was the trade allocated to a broker-dealer based on research the adviser receives rather than the quality of execution provided to the fund? Could a lower commission have been paid if the adviser hadn't received the research? Did the need for research prompt the adviser to place trades it might not otherwise have placed? Are other funds or clients of the adviser unfairly benefiting from research a fund's trades pay for?

(2) The OSC Compliance Team's 2003 Annual Report. notes that OSC staff identified issues with respect to soft dollars, conflicts- of- interest and best price and execution (among other issues). It declared the need for better documentation on the selection process for broker services, written guidelines on the use of soft dollars and improved books and records. The Report further recommended that a list of all soft-dollar arrangements be maintained. This list should include the name of the broker or other entity involved, the nature of the goods or services received by the Registrant and the approximate annual amount of commissions on securities transactions needed to satisfy each arrangement. The report also stated that as part of the process of adequately monitoring portfolio sub- advisors, the due diligence of market participants should include assessing the adequacy of the subadvisor's internal policies in the area of "soft dollar" arrangements.

(3) An August 2004 Wharton School study ***Caught Between Two Principals*** **by** Nicolaj Siggelkow found that U.S. mutual fund providers shift advertising expenses via 12b-1 fees and research expenses via soft dollars (excess commissions paid by fund providers) on to fund shareholders. The study found no evidence that excess payments of brokerage commissions (soft dollars) are used to lower the explicit research fees that fund providers charge. According to the author these results suggest that, at a minimum, soft dollar arrangements should be made more transparent. Expense shifting is much more pronounced for retail funds than for institutional funds, while it is much less affected by competition among fund providers. Bottom line: after examining thousands of funds, Siggelkow concluded that fund managers *do* exploit opportunities to maximize fees, often using techniques that make fees virtually invisible to investors. The paper is available at http://knowledge.wharton.upenn.edu/papers/1280.pdf

(4) In March 23, 2004 testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, Mercer Bullard, President of Fund Democracy, Inc. said:

"The Commission's partial expense ratio also distorts managers behavior because it creates an incentive for them to pay for non-execution expenses with fund commissions. Under current law, fund managers can payer higher commissions. that is, more than it would cost merely to execute the fund's trades in return for non-execution services. By paying for these non-execution services with commissions, or what are known as soft dollars, fund managers effectively move these costs out of the expense ratio where they belong. This enables the fund that uses soft dollars to show a lower partial expense ratio than a fund that does not even if the fund managers use identical services and have identical operating expenses. The Commission itself has conceded that. [t] he limited transparency of soft dollar commissions may provide incentives for managers to misuse soft dollar services. [30] Furthermore, the nondisclosure of portfolio transaction costs exacerbates the conflict of interest that is inherent in the payment of soft dollars. As the Commission has recognized, [s] oft dollar arrangements create incentives for fund advisers to (i) direct fund brokerage based on the research provided to the adviser rather than the quality of execution provided to the fund, (ii) forego opportunities to recapture brokerage costs for the benefit of the fund, and (iii) cause the fund to overtrade its portfolio to fulfill the adviser's soft dollar commitments to brokers. 31 [31] Donaldson Memorandum at 36, supra note 24. Regarding directed brokerage, the Commission recently stated: .We believe that the way brokerage has been used to pay for distribution involves unmanageable conflicts of interest that may harm funds and fund shareholders. Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Rel. No. 26356 at Part II (Feb. 24, 2004). .

While certain aspects of U.S. regulations and Canadian regulations are different, there is no question that since *best execution* is so difficult to measure, a wide number of abuses using soft dollars can easily infest a mutual fund. A copy of his insightful presentation is available at
http://www.funddemocracy.com/Senate%20Banking%20Testimony%203.23.04.pdf