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

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

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

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

The National Society of Compliance Professionals ("NSCP")[1] appreciates the opportunity to comment on proposed National Instrument 23-102 ("proposed instrument") and Companion Policy 23-102 ("companion policy") recently published by the Canadian Securities Administrators ("CSA"). The proposed instrument and companion policy clarify how money managers can use client brokerage commissions to pay for order execution services and/or research ("soft dollar" arrangements) and include guidelines regarding disclosure of "soft dollar" arrangements to clients.

The proposed instrument and companion policy is of considerable interest to the NSCP and its members. The NSCP is the largest organization of securities industry professionals devoted exclusively to compliance issues, effective supervision and oversight. The principal purpose of the NSCP is to enhance compliance in the securities industry, including firms' compliance efforts and programs and to further the education and professionalism of the individuals implementing those efforts. An important mission of the NSCP is to instill in its members the importance of developing and implementing sound compliance programs across-the-board.

The NSCP supports the CSA's efforts to clarify the guidance concerning the use of client commissions for research and order execution services. Nevertheless, the NSCP is concerned about certain aspects of the proposed instrument and companion policy. First, the NSCP is concerned that the proposed instrument and companion policy do not accurately address the realities of the use of client commissions within the brokerage community. Second, the NSCP believes the proposed instrument and companion policy do not appropriately assess the cost impact for small firms. Third, the NSCP believes that while the disclosure relating to "soft dollar" arrangements is necessary, the standards for such disclosure warrant further consideration. Finally, the NSCP believes that the proposed instrument and companion policy relating to eligible soft dollar arrangements may have adverse consequences to the market for third party research. These concerns, as well as other NSCP comments and suggestions, are discussed below.

I. THE AVAILABILITY AND/OR RECEIPT OF RESEARCH AND OTHER SERVICES FROM A BROKER-DEALER BUT NOT REQUESTED BY THE MONEY MANAGER DOES NOT IMPLICATE THE CONFLICTS OF INTEREST INHERENT IN THE USE OF CLIENT COMMISSIONS

From a fundamental perspective, we believe that the proposed instrument and companion policy do not accurately reflect the manner in which research services are provided within the brokerage industry in exchange for client commissions. The framework presented in the proposed instrument and companion policy presumes that "research services" are uniformly bought by money managers rather than made available to money managers by broker dealers as part of their bundled offerings. Further, the framework for determining whether a given product or service is "research" or "brokerage" should be expanded and clarified with respect to some

[1] Headquartered in Cornwall Bridge, CT, NSCP is a nonprofit, membership organization dedicated to serving and supporting compliance officials in the securities industry. Since its founding in 1987, NSCP has grown to over 1,500 members, and includes securities industry participants from the various Canadian provinces, the US and internationally. The constituency from which its membership is drawn is unique. NSCP's membership is drawn principally from investment advisers, traditional broker-dealer firms, accounting firms, and consultants that serve them. The vast majority of NSCP members are compliance and legal personnel spanning a wide spectrum of firms including employees from the largest brokerage and investment management firms to those operations with only a handful of employees. The diversity of our membership allows NSCP to represent a large variety of perspectives in the asset management industry.

services, specifically order management systems provided by broker-dealers. Finally, the relationship between "research" and "order execution" should be developed in more detail.

Research Services Made Available to but Not Purchased by Money Managers

Many money managers use client commissions to obtain either proprietary or third party research from broker-dealers. Just as often, a broker-dealer will provide its own research in connection with the execution of client trades even where the money manager has not requested such research and will not use it in the process of making investment decisions. In such cases, the research services are not purchased by the money manager; they are simply included by the broker-dealer as part of its overall offering. In fact, in many instances, the research provided by a full-service broker-dealer is provided to all money managers who use its platform, i.e., it is provided to a money manager who has not requested it, who may not have traded with the broker-dealer recently and who will not use it in making investment decisions for its clients. In such situations, there is no inherent conflict of interest and a money manager should not be open to claims that it has violated its fiduciary duties, provided that all of the relevant factors evaluated as part of the money manager's best execution analysis are met.

The proposed instrument and companion policy appear to imply that all research obtained with client commissions is (i) requested by the money manager and (ii) used by the money manager in the process of making of investment decisions. However, this implication does not take into account a significant historical context and current industry practices. In a typical "soft dollar" arrangement, money managers use client commissions to obtain research and other products and services from broker-dealers. A fundamental element of such arrangements is consideration. That is, "soft dollar" arrangements typically involve the "exchange" of commission dollars for products and services. We urge the CSA to recognize that the availability of the bundled items, including eligible and ineligible products and services, may <u>not</u> be a factor in a particular money manager's decision to place trades with a specific broker-dealer under circumstances where full service broker-dealers customarily provide research and other services bundled in with execution.

A money manager may select a specific broker-dealer to execute trades based upon its skill in placing a difficult trade, its position in the market, its historical relationship with money manager, the commission charged for the execution of the trade, or any of the myriad of factors considered when evaluating best execution. Frequently, the receipt of research and other bundled materials is not a factor in the money manager's decision to use a specific broker-dealer, and the money manager may have received a lower commission rate had it traded through a broker-dealer that did not deliver these non-requested proprietary services. We believe that under circumstances where a broker-dealer includes, as part of its bundled offering, research and/or services that are not requested or used by a money manager, the traditional elements of a "soft dollar" arrangement are not present. Accordingly, we believe that such situations (i.e., those that do not involve an exchange of commission dollars for products and services) should not be characterized as "soft dollar" arrangements and should not be subject to the framework set forth in the proposed instrument and companion policy. We encourage the CSA to consider clarifying these issues in its final release and to limit the application of the regulatory framework for "soft dollar" arrangements to only those situations in which a money manager is actually utilizing client commissions to obtain research that will be used in the process of making investment decisions.

We do acknowledge that the availability of bundled products and services may pose a conflict of interest for money managers. To the extent a money manager receives products and

services from a broker-dealer on an unsolicited basis for a bundled commission rate and **uses** any of those products and services, the money manager should be subject to the rules contained in the proposed instrument for those particular products and services.

The Temporal Standard with respect to "Order Execution Services" may not Reflect the Industry Needs and Practices

The NSCP is concerned that the temporal standard for "order execution services" as defined in the proposed instrument and companion policy is contrary to long-standing industry practice. Section 1.1 of the proposed instrument defines order execution services as "order execution; and other goods and services directly related to order execution." As described in the companion policy, "'order execution services' means the entry, handling or facilitation of an order by a dealer, but not other tools that are provided to aid in the execution of trades." Traditionally, the CSA has defined "order execution" more broadly, leading market participants to develop a practice of paying for certain products, such as order management systems, with soft dollars. Many advisers use OMS to model, prepare and analyze prospective trades prior to the moment the trade order button is pushed. In our view, OMS certainly have a "research" function, but we believe that they have become an important characteristic of integrated adviser to broker order execution platforms.

Relationship between "Research" and "Order Execution Services"

As noted above, the proposed instrument and companion policy set forth new interpretations of "research" and "order execution" services. While some products and/or services may fall outside of the scope of "soft dollar" arrangements with respect to one definition, some of those products and/or services meet the conditions set forth with respect to the other definition. For example, an OMS or trade analytical system may be interpreted under the proposed instrument and companion policy as not sufficiently related to an "order execution" service because the use of such system occurs either before the money manager communicates with broker-dealer or after the securities are delivered, but such a tool provides valuable "intellectual content" in the form of reports or analysis concerning the impact specific trade decisions in portfolios, i.e. "research" with a view to improving or enhancing future trade decisions and trade execution.. The proposed instrument and companion policy are unclear as to whether or not a product or service specifically excluded from either "research" or "order execution service" may fall within the eligible "soft dollar" arrangement definition. We believe that an OMS or trade analytical system, even if not considered "order execution services," may still qualify as permitted research and we request that the CSA specifically consider this position in its final instrument and companion policy.

II. THE PROPOSED INSTRUMENT AND COMPANION POLICY UNDERESTIMATE THE BUSINESS PROCESS CHANGES AND TECHNOLOGICAL AND OTHER COSTS ASSOCIATED WITH PROPOSED DISCLOSURE REQUIREMENTS

Associated Costs for Implementing the Disclosure Requirements

One of the stated goals of the policy initiative is to provide investors with more information about their adviser's use of soft dollar commissions. The NSCP applauds the CSA for taking the position that enhanced disclosures are needed to notify investors of potential conflicts of interest and the use of commissions for acceptable soft dollar arrangements.

The proposed disclosure would require the adviser to disclose:

- The arrangements entered into relating to the use of brokerage commissions as payment for order execution services or research;
- The names of the dealers and third parties that provided these goods and services;
- The general types of goods and services provided by each of the dealers and third parties; and
- In certain circumstances, the amounts of commissions paid by the adviser during the period reported, including for each client:

    - The total brokerage commissions for each security class (equity, options, etc.) both on behalf of all clients and on behalf of that client;
    - Trades where clients receive only order execution from dealers and no other services;
    - Trades where the client receives bundled brokerage services; and
    - Trades where part of the commission paid is directed to third parties. Where this applies, advisers must make reasonable efforts to disclose to each client and in the aggregate the **percentage** of total brokerage commissions used for third-party research, third-party services and the dealer's portion. In addition, the adviser must estimate and disclose the **weighted average** brokerage commission **per unit** of security corresponding to the commissions underlying each of those percentages.

The CSA acknowledges that the increased disclosure standard is likely to result in up-front costs as advisers alter their current practices and procedures to track the necessary level of detail on an ongoing basis. The CSA's analysis of these costs appears to be predicated upon an assumption that the required information would be readily available to the adviser and that the necessary changes to the adviser's business processes would be limited to how that information is stored and manipulated. In addition, the CSA assumes that ongoing reporting costs will be mitigated if changes are made at the outset with respect to the methodology for collecting the required information.

The NSCP believes that the CSA's analysis of the costs associated with the new standard may not have taken into account all of the expenses that advisory firms will be required to bear, especially in view of the scope and extent of the disclosure contemplated by the proposed instrument and companion policy. Although the CSA's Cost-Benefit Analysis includes an estimate of the number of firms that will be affected by the policy initiative, it does not consider the probable impact of the costs of implementation on smaller firms.

The proposed instrument requires some general annual disclosure that is similar in content to certain existing requirements, but introduces a number of additional disclosure components. The proposed disclosure relating to commissions paid would require firms to engage in an analysis of transaction costs in order to develop "reasonable estimates" of transaction costs for various types of transactions and, in addition, the weighted average brokerage commission per unit of security in certain transaction categories. Furthermore the proposed instrument would require firms to track individually every item received from a broker-dealer (i.e., each research report, telephone call, analyst meeting) whether used by the firm or not. In addition, firms would have to track the name of the individual who received the information in order to tie it to a specific client.

The NSCP is under the impression that the Canadian adviser marketplace, in particular smaller firms, currently does not have in place the requisite technology systems to provide the level of detailed reporting contemplated by the new disclosure standard. The NSCP believes that very few service providers offer the type of analysis that would be required in order to provide this type of reporting and that the costs attendant to the required analysis would be substantial, especially for smaller firms. Consequently, if an advisory firm were to seek to rely upon a third-party service provider for its transactional reporting and analysis (assuming that a third party provider could perform this function), it is highly likely that some of the data reported could be inaccurate. The collection and reporting of inaccurate data certainly would not be a benefit to investors. Furthermore, in order for the firm to act fairly, honestly and in good faith, it is likely that the firm will have to reconcile information received from the third-party service provider in order to ensure its accuracy. In turn, this will necessitate the need to hire additional staff. Small firms might not be able to afford to engage third-party services or hire additional staff to manually separate the transactions by category, calculate the amounts, percentages and weighted averages and track individually each research service (especially when received as part of a bundled package).

The detailed disclosure contemplated by the proposed instrument and companion policy currently is not required by the Securities and Exchange Commission in the United States or by the Financial Services Authority in the United Kingdom. The NSCP believes that a consistent approach among regulators is highly desirable, especially in view of the fact that many advisers operate in Canada and the United States. We also note that there could be significant costs associated with production of multiple disclosure reports; (e.g., one report for clients within the United States and a separate, more detailed disclosure report for Canadian clients).

Rather than adopt the disclosure requirements as proposed, we encourage the CSA to consider regulatory parity with respect to its proposed disclosures for multi-jurisdictions and throughout Canada. Given the potentially disruptive effects of the proposed disclosure requirements, the CSA may wish to consider forming a special focus group, or task force to focus solely on the disclosure aspects of the proposed instrument and companion policy to collect further perspective from market participants, investors and other regulatory bodies prior to adopting its final requirements in this area. Similarly, the CSA may wish to consider mandating the same disclosure requirements for Canadian private clients, Canadian fund clients and foreign jurisdiction clients (such as in the United States and United Kingdom). We believe that taking a streamlined, consistent approach towards disclosure will result in reduced additional costs, increased transparency and enhance clarity for all market participants.

III. THE PROPOSED DISCLOSURE IS NECESSARY BUT SHOULD TAKE AN ABBREVIATED FORM

The CSA has expressed the view that the disclosure of transaction-specific commission data, including the amounts, percentages and weighted averages, would increase transparency regarding brokerage commissions paid on the clients' behalf by helping them to better assess the use of brokerage commissions by their advisers. While we believe that it is important for clients to be provided with disclosure concerning "soft dollar" arrangements, the NSCP believes that the scope and extent of the disclosure contemplated by the proposed instrument and companion policy is excessive. We view that such disclosure may, from a client perspective, be overly complex and confusing. As noted above, we also believe that, from an industry perspective, compliance with the new disclosure standard will be costly and unduly onerous.

Looking to the disclosure requirements in the United States and United Kingdom, as well as through soft dollar guidance provided by the CFA Institute through GIPS, we believe that the CSA may wish to consider the following disclosures be prescribed.

1. Total Value of Commissions Used
2. Types of Services Purchased with Soft Dollars
3. Percentage of Client Commissions Allocated to Soft Dollars in Each of the Client's Account(s)

We believe that this approach will provide for meaningful information and transparency regarding the brokerage commissions paid on the clients' behalf to broker-dealers. In addition, such information is already captured by most technology management systems of both large and small firms in the Canadian marketplace. Importantly, this type of disclosure will enable firms of all sizes to comply with the requirements using their current systems.

In addition, we propose that the format for disclosure should appear on a single page, which can be enclosed with quarterly client statements. This allow for timely delivery in an investor-friendly format, which is easy to understand.

IV. THE PROPOSED INSTRUMENT AND COMPANION POLICY RELATING TO ELIGIBLE "SOFT DOLLAR" ARRANGEMENTS MAY HAVE ADVERSE CONSEQUENCES TO THE MARKET

We note that the Cost-Benefit Analysis provided by the CSA begins with a statement to the effect that the Ontario Securities Commission (OSC) is committed to delivering cost-effective regulation. A fundamental principle identified in the *Securities Act* is that "[b]usiness and regulatory costs and other restrictions on the business and investment activities of market participants should be proportionate to the significance of the regulatory objectives sought to be realized".[2] While we support the CSA's efforts to clarify the guidance concerning the use of client commissions for research and order execution services, we encourage the CSA to explore fully the potential consequences of a disclosure regime that includes multiple transactional metrics. We believe that it is both prudent and possible to develop standards for meaningful disclosure that will provide a consistent standard throughout Canada without imposing disclosure requirements that many firms may not be able to address. And, while we have not undertaken a study of the relative sizes of investment management firms throughout Canada, we wonder whether a regulatory regime that is too onerous for many industry participants could have the unintended effect of forcing consolidation in the financial industry, thereby limiting investor choices and available third-party research.

[2] Securities Act, RSO 1990,c.S.5,2.1(6)

V. OTHER RECOMMENDATIONS

Finally, we encourage the CSA to consider a phase-in period once the final instrument and companion policy are released. This will allow firms to evaluate their existing internal controls and to enhance current processes, staffing and technology, as needed, to comply with the CSA's requirements.

In addition, the NSCP believes that the CSA should consider forming a focus group to address the concerns voiced by the NSCP and others prior to finalizing the instrument and companion policy. This will allow for a sharing of ideas, particularly of broker-dealers and investment advisers, who can best provide insight into the feasibility, associated costs, and delivery of the additional disclosure and other requirements for eligible soft dollar arrangements.

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We thank the CSA for the opportunity to comment on the proposed instrument and companion policy and we hope that you find these comments useful in preparing the final release. We would be pleased to discuss our views further with the CSA. Please feel free to contact Joan Hinchman at the NSCP at (860) 672-0843 with any questions or comments.

Very Truly Yours,

Joan Hinchman
Executive Director, President and CEO