

October 19, 2006

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

**Re: Notice of Proposed NI 23-102 Use of Client Brokerage Commissions as Payment  
for Order Execution Services or Research (“Soft Dollar” Arrangements)**

Dear Mr. Stevenson:

The Investment Company Institute<sup>1</sup> appreciates the opportunity to comment on the Canadian Securities Administrators proposed National Instrument 23-102 (the “Proposed Instrument”) on the use of client brokerage commissions as payment for order execution services or research. Although the Institute does not directly represent Canadian funds, many of the Institute’s U.S. investment adviser members are also registered in Canada or have significant interests in Canada, either through affiliates or parent companies based in Canada or through direct investments in Canadian markets.

The Institute generally supports the CSA proposal, although that support is predicated on three important clarifications: first, that the application of the Proposed Instrument is limited to those transactions where there are fully disclosed and objectively verifiable brokerage commissions; second, that advisers are not required to specifically allocate the benefit of each research service or product received to particular clients; and third, that the definition of “client” in the retail mutual fund context refers to the fund itself and not the fund’s investors. Our reasons for conditioning our support for the proposal on these clarifications, as well as other specific comments on the Proposed Instrument, are discussed below.

*General Comments*

There are many elements of the CSA proposal that we favor. In particular, we commend the CSA for providing a level playing field for mutual funds and other investment products by requiring

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<sup>1</sup> The Investment Company Institute is the national association of the U.S. investment company industry. More information about the Institute is available at the end of this letter.

that *all* investment advisers comply with the provisions of the Proposed Instrument regardless of the type of client account involved. This is important so that regulation does not create financial incentives for dealers to favor one class of clients over another. We also support the CSA's application of a uniform standard across Canada. In combination, the level playing field and uniform standard would help ensure that client commission arrangements in Canada operate in clients' best interests.

We further commend the CSA for taking into account the approaches of the U.S. Securities and Exchange Commission (SEC) and the U.K. Financial Services Authority (FSA) in formulating its proposals. We are concerned, however, that some of the measures in the Proposed Instrument may introduce disparities between U.S. and Canadian regulations that would make it more difficult for advisers to serve clients in both markets. We hope that the CSA will continue to coordinate with the SEC to achieve a measure of consistency in regulatory approaches that will not disadvantage firms that operate in both the U.S. and Canadian markets.

#### *Application of the Proposed Instrument*

Section 2.1 of the Proposed Instrument specifies that the Instrument applies to all transactions where brokerage commissions have been charged by a dealer. Section 2.1 of Companion Policy 23-102 CP (the "Proposed Policy") explains that the reference to "brokerage commissions" in the Proposed Instrument "includes any commission or similar transaction-based fee." The Proposed Policy and the CSA's notice of the Proposed Instrument (the "Notice") explain that this definition of brokerage commissions could encompass transactions where technically no commissions are charged, but where a transaction fee can be separately broken out.

The Notice observes that both the SEC and the FSA have adopted a narrower view of brokerage commissions than the CSA proposal, and asks whether the Proposed Instrument should be restricted to transactions where there is an "independent pricing mechanism." The term "independent pricing mechanism" is not defined except by the example of transactions in exchange-traded securities.

We strongly believe that the application of the Proposed Instrument should be restricted to transactions where there is an independent pricing mechanism that enables advisers to accurately, consistently, and objectively determine the amount of the commission that a dealer is charging for the transaction.<sup>2</sup> An adviser cannot fulfill its obligations under the proposed rules unless brokerage commissions are fully disclosed to the adviser and are quantified in a generally accepted and verifiable way.

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<sup>2</sup> Under this approach, eligible transactions would include agency transactions in exchange-traded securities, as in the example in the Notice, and other transactions with conditions that provide for independent and objective verification of the fee charged by the dealer. This is the approach the SEC has taken by determining that only transactions that satisfy specific and rigorous requirements provide sufficient price transparency. The SEC interpretation encompasses certain riskless principal transactions reported under specified trade reporting rules of the National Association of Securities Dealers, but excludes other principal or riskless principal transactions where fees are undisclosed or unverifiable. *See* Exchange Act Release No. 45194 (Dec. 27, 2001).

Limiting the application of the Proposed Instrument to transactions with fully disclosed and objectively verifiable commissions is necessary so that an adviser can ensure, as required by subsection 3.1(2)(c) of the Proposed Instrument, that “the amount of brokerage commissions paid by its client(s) for order execution services or research is reasonable in relation to the value of the order execution services or research received.” It is also necessary so that disclosure of brokerage commissions by different advisers is comparable and meaningful to clients. The calculation and disclosure of imputed, unverifiable brokerage commissions would be counterproductive because there is no generally accepted method to determine these imputed brokerage commissions; the resulting disclosure would not be consistent among advisers and would be more likely to contribute to confusion rather than clarity for clients.

For all of these reasons, we recommend that the CSA clarify that section 2.1 of the Proposed Instrument applies only to transactions where there are fully disclosed and objectively verifiable brokerage commissions. The CSA may further wish to specify the types of transactions executed in Canada that satisfy these conditions.

#### *The Framework for Client Brokerage Commission Practices*

The framework in section 3.1 of the Proposed Instrument requires an adviser to use brokerage commissions only as payment for goods and services defined as eligible order execution services or research. The adviser must also ensure that the goods and services benefit the adviser’s client(s), add value to investment or trading decisions, and are reasonable in relation to the amount of brokerage commissions paid. The Institute supports this approach, as it generally establishes a relevant and appropriate framework to ensure that order execution services and research acquired with brokerage commissions are for the benefit of an adviser’s clients.

We are concerned, however, that statements in the Proposed Policy and the Notice might be construed to require that an adviser specifically allocate the benefit of each research service or product received to the particular client whose brokerage commissions were used to pay for that research. Specifically, section 3(a) of the Notice states “[s]ection 4.1(2) of the Proposed Policy also clarifies that in order to ensure that the order execution services or research paid for with brokerage commissions benefit the client(s), the adviser should have adequate policies and procedures in place to ensure that a reasonable and fair allocation of the goods and services received is made to its client(s). *This is necessary so that there is a connection between the client(s) whose brokerage commissions were used as payment for goods and services and the benefits received.*” (Emphasis added.)

In almost all cases, research received by an adviser is used for the benefit of more than one client, and a specific allocation of the benefits of research would be very difficult, or in many cases, impossible. We recommend that the CSA clarify that the Proposed Instrument and Proposed Policy would not require an adviser to specifically allocate the benefit of research services or products to particular clients. Rather, a good faith determination that the amount of commissions paid is reasonable in relation to the value of goods and services received, either with respect to a particular

transaction or the adviser's overall responsibility for client accounts, should satisfy the standard in subsection 3.1(2)(c) of the Proposed Instrument.

*Disclosure of Client Brokerage Commission Practices*

Section 4.1 of the Proposed Instrument mandates certain commission-related disclosures to advisory clients. We strongly recommend that the CSA clarify that the term "client," as used in section 4.1 with respect to advisers that manage mutual funds, refers to the fund itself and not to the fund's investors. We assume that the result of this clarification would be that the newly-mandated independent review committees ("IRCs") would receive the required disclosures. This is an appropriate result, as the types of detailed and complex disclosure required by the Proposed Instrument would overwhelm investors with information that is not meaningfully helpful to their investment decisions. IRCs, much like mutual fund boards in the United States, are in a far better position than individual investors to be able to evaluate the types of commission-related disclosure contemplated by the Proposed Instrument.

For example, we seriously question whether the long and detailed list of dealer information required by subsection 4.1(1)(a) would be meaningful to investors. Advisers generally use multiple dealers and other service providers, each of which provides a number of services, both solicited and unsolicited. As a result, the required list could stretch on for pages and still provide investors with little understanding of how an adviser values and uses the services that are provided. This information, which is generally considered proprietary, would also become publicly available if provided to investors. IRCs would be in a better position to interpret and contextualize the information while maintaining its proprietary nature.

Even with a clarification that IRCs are the appropriate recipient of required client disclosures, we have concerns about the overall level of specificity in section 4.1 of the Proposed Instrument. For example, subsection 4.1(2) would require advisers to maintain "details" of each good or service that was paid for with brokerage commissions. These details include a description of the good or service received, the name of the dealer that used the brokerage commission as payment for a good or service or forwarded the brokerage commission to a third party, the name of the third-party provider, if any, and the date the good or service was received. These types of internal adviser records may be relatively simple to maintain for items like written research reports requested and purchased by an adviser, but we are concerned that they would be difficult or impossible to create for many other types of order execution and research services. For instance, access to research analysts, advice from a dealer as to how to trade an order, and many other intangible services provided by full-service brokers would be extremely difficult to document in the specified form.

Instead of the detailed recordkeeping requirements of subsection 4.1(2), we recommend that advisers be permitted flexibility to determine how to document the goods and services received from brokers, so long as the records provide adequate documentation that the adviser made only permissible

uses of brokerage commissions and the records are made available to regulators in the inspection process.

*Definitions of Order Execution Services and Research*

The Institute supports clarifying what types of goods and services may be received by advisers in exchange for brokerage commissions.<sup>3</sup> We generally support the definitions and guidance in the Proposed Instrument and Proposed Policy on the types of goods and services that may be paid for with brokerage commissions. More specifically, we support the decision to assign the adviser the responsibility to determine that a good or service paid for with brokerage commissions satisfies the definitions and that it benefits clients, and we agree with the guidance in the Proposed Policy that “[w]here mixed-use items are received by an adviser, the adviser should make a reasonable allocation of the brokerage commissions paid according to the use of the goods and services.”

We are concerned, however, that some interpretive guidance in the Proposed Policy would result in differential treatment of goods and services in Canada and the United States that could create problems because of the close proximity of our markets and the number of advisers and dealers that operate in both markets. Our particular concerns in this regard, as well as our comments with respect to specific topics or types of services discussed in the Notice, are explained below.

- *Order management systems.* We support the treatment of order management systems as mixed-use items. The term “order management systems” encompasses a variety of different systems with different features. Advisers use order management systems for a range of purposes, many of which would qualify under the proposed definitions as either order execution or research services. For example, order management systems may incorporate order execution services such as order entry, building a trade, and connectivity or routing functions that facilitate the execution process. They may also incorporate analytic tools that assist advisers in making investment decisions. These may be combined with non-eligible functions such as compliance tools. It is important to maintain a flexible approach that permits order management systems to be treated as mixed-use services because they are evolving and likely will change over time with new developments in technology and the proliferation of new ways to trade securities.
- *Proxy voting services.* We believe that the guidance should explicitly permit advisers to treat proxy-voting services as a mixed-use item in appropriate circumstances. Proxy voting firms typically provide two types of services: (1) research and analysis of matters to be voted on, with a recommendation on how to vote; and (2) the administrative functions of receiving, voting and returning ballots, and reporting on votes cast. The first category can include research eligible under the definition and guidance in the Proposed Instrument and Proposed Policy. For example, we understand that proxy-voting services often provide advisers with background

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<sup>3</sup> See, e.g. Letter from Paul Schott Stevens, President, Investment Company Institute, to Mr. Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated November 25, 2005 (File No. S7-09-05).

information about issuers in connection with analyses of proxy proposals. If such information is provided to and used by an adviser's investment personnel to assist with investment decision making, it should be considered research if it otherwise meets the eligibility requirements for research under the definition and guidance. Similarly, advice on how to vote proxies might properly be deemed to qualify as research to the extent it assists the adviser in making investment decisions. For example, advice with respect to voting on a company's merger proposal may be relevant to a manager's decision whether to continue holding, sell, or buy more shares of that company.

- *Publicly available information or publications.* We recommend clarifying the definition of "publicly available information or publications" in the Proposed Policy. We agree with the exclusion of mass-marketed publications, which we understand to be publications marketed and circulated to the general public and intended for a broad, public audience. It is less clear what is meant in the Proposed Policy by "publicly available information or publications." Many narrowly focused and targeted research products could be considered "publicly available," depending on the definition of that term. For example, the purchase of a research product may not be restricted, although the research is not marketed and circulated to the general public. We recommend clarifying the scope of this restriction to facilitate compliance.
- *Raw market data.* We are concerned with the CSA's proposed exclusion of raw market data from the definition of eligible research services. We understand that some advisers registered in both the United States and Canada currently offer their Canadian clients quantitative trading strategies that invest in U.S. markets and rely on raw market data purchased with brokerage commissions. If raw market data were excluded from the definition of eligible research in Canada, advisers would either have to alter their method of trading for the benefit of their Canadian clients or separate the trades of their Canadian clients from the trades of their U.S. clients to ensure that the trades of Canadian clients are not done with a dealer providing raw market data. This would increase trading costs and create a disincentive for offering quantitative trading strategies to Canadian clients.

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We appreciate the opportunity to express our views on this important topic. If you have any questions about our comments or need any additional information, please contact me at 202-371-5430, or Glen Guymon at 202-326-5837.

Sincerely,



Robert C. Grohowski  
Senior Counsel– International Affairs

Mr. John Stevenson

October 19, 2006

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### **About the Investment Company Institute**

The Investment Company Institute seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. The Institute's membership includes 8,821 open-end investment companies (mutual funds), 654 closed-end investment companies, 234 exchange-traded funds, and 4 sponsors of unit investment trusts. Mutual fund members of the Institute have total assets of approximately \$ 9.468 trillion (representing 98 percent of all assets of US mutual funds); these funds serve approximately 89.5 million shareholders in more than 52.6 million households.