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Via Electronic Mail

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Re: Proposed National Instrument 23-102 - Use of Client Brokerage Commissions as Payment for Order Execution Services or Research ("Soft Dollar" Arrangements)

Ladies and Gentlemen:

BNY ConvergEx Group LLC ("BNY ConvergEx") is pleased to submit this letter in response to the Canadian Security Administrators' ("CSA") request for comment to the proposed National Instrument 23-102 ("Proposed Instrument") and the related proposed Companion Policy 23-102 CP ("Proposed Policy").

BNY ConvergEx supports the CSA's endeavor to clarify the provisions made in OSC policy 1.9 *Use by Dealers of Brokerage Commissions as Payment for Goods and Services other than Order Execution Services* and the Autorité des marchés financiers AMF Policy Statement Q-20.

We applaud the CSA's efforts to clarify the scope of products and services that constitute "execution services" and "research" and are supportive of its considerable efforts to achieve regulatory consistency with the U.K. Financial Services Authority (the "FSA")

and the U.S. Securities and Exchange Commission (the "SEC"). Furthermore, we agree with the CSA's acknowledgement that soft dollar arrangements apply to both bundled, proprietary services as well as third party, independent research services. As a respectful suggestion, we encourage the CSA to strive for a transparent disclosure regime that treats proprietary research and independent research equitably.

BNY ConvergEx has been actively involved in the regulatory discussion surrounding the use of client commissions in Canada, the U.K. and the U.S. We have maintained support for advisors' ability to obtain those services that will aid in the investment decision-making process, while encouraging enhanced disclosure and transparency to investors.

BNY ConvergEx

BNY ConvergEx comprises BNY Brokerage, LLC; Lynch Jones & Ryan LLC; Westminster Research Associates LLC; BNY Jaywalk LLC, Eze Castle Software LLC and G-Port, a division of G-Trade Services LLC. BNY ConvergEx is committed to providing institutional clients, such as investment advisors, institutional investors and broker-dealers, with a broad range of agency brokerage, commission management, independent research, transition management, trade order management and related investment technology solutions. Currently, we are one of the largest providers of independent research and agency execution, administering approximately one-third of independent research arrangements ("soft dollar" arrangements) in the United States.

Response to Specific Request for Comments

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?

We recommend that the application of the Proposed Instrument should be restricted to those transactions where there is an independent pricing mechanism.

However, as in the U.S., we feel that those OTC trades transacted on a riskless principal basis, when a dealer takes OTC shares into inventory, and then applies a transparent markup to the advisor, should be within the scope of the Proposed Instrument. In the U.S., the SEC provided interpretive guidance on riskless principal transactions in December of 2001,[1] stating that such transactions, in which both legs are reported at once, in the same manner as an agency transaction, are eligible to be used to pay for research.

[1] In 2001, the SEC released interpretation 17 CFR Part 241 (SEC Release No. 34-45194.) This clarified that riskless principal trades are eligible to pay for research.

Question 2. What circumstances, if any, make it difficult for an advisor to determine that the amount of commissions paid is reasonable in relation to the value of goods and services received?

With those commissions paid exclusively for execution services and for third party research services, the price of execution and research is completely transparent and therefore discernable by the broker and the advisor. The broker can easily track the amount expended on execution services and third party research services, and report this detail back to the advisor for disclosure purposes.

The difficulty an advisor has in determining whether the commission paid is reasonable in relation to the goods and services delivered lies in getting a more detailed analysis of those services from proprietary or bundled brokers, or in a form similar to the U.K. Investment Management Association's ("IMA") disclosure regime introduced earlier this year.

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".

Certain aspects of an Order Management System (OMS) provide lawful assistance in the money manager's investment decision-making process and therefore constitute "research" services. Other aspects of an OMS fall within the CSA's temporal limitation and therefore should be considered "order execution" services.

Below is our analysis of the role that an OMS plays in the "research" and "order execution" processes.

<u>Application of an OMS in the Research Process</u>

The Eze Castle OMS, owned by BNY ConvergEx, includes various tools and functions integral to the order creation process that constitute quantitative analytical software providing analysis of securities portfolios and reflect an expression of reasoning or knowledge. For example:

- Our market data integration tool with its alert and warning tools and real-time market stamping enables the money manager to make or revise investment decisions on an intra-day basis and assess important factors including the quality of executions.
- Our portfolio profit/loss and risk monitoring tool enables the money manager to monitor and react to real-time intra-day changes to important risk ratios, arbitrage ratios, hedge ratios and risk characteristics which result in reactive trades and revised intra-day trading strategies.
- Our portfolio, security, and strategy modeling and analysis product enables advisors to create model portfolios and perform "what if" analyses with respect to hypothetical rebalancing and asset allocation, which in turn leads to updated investment decisions.

- Our pre-trade analytic interfaces interconnect pre-trade analytic tools and the money manager's trade blotter enabling a money manager to analyze a proposed trade and its potential execution cost impact.

Application of an OMS in the Order Execution Process

BNY ConvergEx's OMS includes many aspects that not only fall within the CSA's temporal limitation, but represent integral parts of the trade execution and trade settlement process. In particular, the following functions embedded in our OMS are important tools to the order execution and order settlement processes:

Order Execution

- Our listed trading tool (with its wave trading components) is instrumental in the money manager's communication of his or her trade order to the sell-side broker.
- Our software functionality that integrates with connectivity services provided to the sell-side broker is an integral part of the money manger's initiation of the electronic communication of an order.
- Our interface functionality with order routing and algorithmic trading tools offered by sell-side brokers is instrumental in the communication by the money manager of his investment decision.

Order Settlement

- Our trade data aggregation, management, transfer, and straight-through processing service involves all of the following examples of brokerage:
    - post-trade matching;
    - electronic communication of allocation instructions between institutions and broker-dealers; and
    - routing settlement instructions to custodian banks and broker-dealers' clearing agents.
    - in addition, our suite of reconciliation tools provide post-trade matching services as well as other instrumental functions to ensure that the proper amount of securities and cash is credited to the money manager's account at the time of settlement and clearing.

OMS offerings have generally evolved to include a broad range of functionality that spans from a money manager's investment idea creation process all the way to order execution, settlement and clearing. As such, we believe that these suites of software services and products contain certain components that clearly fall within the definition of "research" and others that clearly fall within the temporal limitation set forth by the CSA, and, as such, should be considered "order execution services."

In the U.S., after much discussion and analysis, the SEC concluded that many functions of OMS are eligible as brokerage, provided they fall within the temporal standard set forth and are not used for recordkeeping, compliance or administrative purposes.

Additionally, the SEC indicated that many functions of the OMS might qualify under the "research" prong of the safe harbor. As such, many U.S. managers will continue to treat OMS as a mixed-use item, with both eligible brokerage and research functions.

Question 4. Should post-trade analytics be considered order execution services? If so, why?

We recommend that post-trade analytics be considered a mixed-use item. A portion of post-trade analytics systems can be a valuable research tool for determining which brokers and execution venues have helped achieve "best execution" in past transactions. Furthermore, to the extent that post-trade analytics can be used to decide *when, where* and *how* to trade they may also fall within the definition of brokerage services. The portion of these services used for recordkeeping, administrative and compliance purposes should be paid for directly by the advisor.

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.?

We believe it is important for the OSC to recognize similarities in the approaches taken by both the SEC and the FSA in determining the treatment of goods and services such as market data and others. By providing principle based rules, and allowing fiduciaries to decide on the appropriateness of specific research input (outside of a limited list of non-permitted services in the U.K. and non-eligible services in the U.S.) both the FSA and the SEC have afforded fiduciaries a degree of latitude to accommodate differing investment styles and needs.

Differing country standards regarding the eligibility of specific services creates a need for a global advisor to manage disparate rule sets while at the same time trying to implement a single, global disclosure protocol. This can create an unnecessary compliance burden. Some global advisors might be competitively disadvantaged as they seek to limit the services used in their investment decision-making process to comply with the most restrictive country standards.

The SEC recognized this in their finalized guidance in July of this year.

> *"With the globalization of the world's financial markets, many U.S. participants have a significant presence abroad, and in particular in the United Kingdom. To the extent that the Commission's approach to client commissions is compatible with that taken in the United Kingdom market participants costs of compliance with multiple regulatory regimes are reduced."* [2]

Additionally, if one country standard was viewed as particularly constrictive relative to others, it might result in a flight of assets to markets with a more favorable regulatory

[2] Securities Exchange Act Release No. 54165 (July 18, 2006).

environment. This concern has been voiced by many industry constituents at the onset of both the FSA and SEC reviews of commission practices.

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?

We believe that raw market data fits properly within the scope of services that an advisor should be permitted to receive in exchange for commissions. As discussed in the SEC interpretive release, the inclusion of market data within the Section 28(e) safe harbor "will promote innovation by money managers who use raw data to create their own research analytics, thereby leveling the playing field with those money managers who buy finished research, which incorporates raw data, from others."[3] We believe that the role of raw market data will become increasingly important to the investment process as managers continue to insource their research efforts.

Additionally, advisors who manage quantitative funds largely rely on raw market data to achieve best execution of orders and to optimize quantitative investment strategies. Those advisors with such quantitative investment strategies would be at a competitive disadvantage to those advisors with a primarily fundamental approach if market data were excluded from the definition of research services in the Proposed Instrument.

Question 7. Do advisors currently use client brokerage commissions to pay for proxy-voting services? If so, what characteristics or functions or proxy-voting services could be considered research? Is further guidance needed in this area?

Many advisors currently use client brokerage commissions and the mixed-use allocation process to pay for proxy services. In particular, those elements of the services that contain analyses, reports and information about issuers, securities and the advisability of investing in securities are valuable tools to the investment decision-making process and should continue to be eligible to be paid for with client brokerage commissions. Conversely, any elements of the proxy services that handle the mechanical aspects of voting, such as casting, counting, recording and reporting votes should not be eligible to be paid for with client brokerage commissions.

It would be helpful for the CSA to offer additional guidance in this area. In particular, we would like the CSA to consider whether those components of proxy services that are used by managers in deciding how to vote proxy ballots are analogous to traditional "maintenance research," and as such, should be eligible to be paid for with client brokerage commissions.

[3] Ibid, page 5.

Question 8. Do advisors currently use client 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 advisor to make reasonable allocations between the portions of mixed-use goods and services that are permissible (for example, for post-trade analytics, order management systems, or proxy voting systems)?

Advisors are paying for those portions of services such as order management systems, post trade analytics systems, and proxy voting services used for research and brokerage purposes with client commissions.

It is important that the advisor, as the user of the given service, make a good faith determination as to the allocation of research, brokerage, and administrative functionality. When determining this allocation the advisor should keep adequate books and records concerning allocations in order to make an accurate good faith representation.

Furthermore, this allocation process is becoming easier for the advisor as vendors are providing more guidance as to the research, brokerage and administrative components of their products and services.

Question 9. Should mass-marketed or publicly-available information or publications be considered research? If so, what is the rationale?

We have supported the SEC's clarification that mass-marketed publications should not be acquired with client commissions and encourage the CSA to issue the same guidance. Mass-marketed publications are those publications that are intended for and marketed to a broad, public audience. Such mass-marketed publications are more appropriately considered as overhead expenses.

However, many advisors purchase arcane, limited distribution, industry specific trade journals for their research needs. They include medical, engineering, energy, geology, metallurgy and pharmacology journals, to name a few. These publications in many ways are limited in distribution to a few thousand subscribers and the cost of these publications, whether provided electronically or in hard copy, are priced in the thousands of dollars a year. Although price and circulation should not be determinative of whether a subscription is a permitted research service, perhaps whether or not the periodical is oriented toward the general public should.

Question 10. Should other goods and services be included in the definitions of order execution services and research? If so, what is the rationale?

We believe that the existing policy, which provides examples of commonly encountered goods and services that may be considered order execution services or research, provides sufficient and practical guidance. We support a framework that applies "high-level principles" rather than a narrowly defined rule set.

It is critical that advisors - the users of the services - be permitted the flexibility, acting within their fiduciary duty, to determine which services assist them in the investment decision-making process. In contrast, maintaining lists defining exactly which services could or could not be paid for using commissions would be cumbersome and unworkable. It is important to note that a similar approach has proved workable in the U.S.[4] The SEC's 2006 release clearly reaffirms the principles set forth in the SEC's 1986 release which considers an advisor to be operating within the safe harbor if the research services being used satisfy the statute's definition of "brokerage and research services" in Section 28(e)(3), and provide lawful and appropriate assistance to the money manager in the performance of his investment decision-making responsibilities.

Generally, as investment management organizations continue to develop and rely more on their own in-house research efforts, they will need to maintain both the flexibility of sourcing research from many disparate sources and the latitude to determine what constitutes value-added research that enhances their investment management process.

Question 11. Should the form of disclosure be prescribed? If prescribed, which form would be most appropriate?

Please see below response to Question 12.

Questions 12. Are the proposed disclosure requirements adequate and do they help ensure that meaningful information is provided to an adviser's clients? Is their any other additional disclosure that may be useful for clients?

We suggest that the CSA recognize and monitor the enhanced disclosure initiative implemented by the IMA in the U.K., as well as the disclosure initiatives now being discussed and formulated by the SEC Division of Investment Management in the U.S.

By requiring advisors to further "sub-divide" third-party commissions into additional categories (i.e. third-party research, other third-party services and the dealer's portion), we believe that the proposed disclosure requirements treat independently produced research and proprietary, sell-side street research inequitably. While disclosure surrounding the costs of research and execution are necessary to provide transparency,

[4] In 1986, the SEC set forth a new controlling principle to be used in determining whether a service is research that has been easy to understand. (SEC Release No. 34-23170.) This replaced the 1976 definition of research, which carved out "products and services which are readily and customarily available and offered to the general public on a commercial basis", which proved largely unworkable.

we believe it is necessary to have a disclosure protocol that does not discriminate against any one class of research.

As the SEC reiterated in the 2006 Release, "Section 28(e) applies equally to arrangements involving client commissions paid to full service broker-dealers that provide brokerage and research services directly to money managers, and to third-party research arrangements where the research services and products are developed by third parties and provided by a broker-dealer that participates in effecting the transaction."

We believe that any disclosure should treat all research equitably, regardless of where it is produced.

Question 13. Should periodic disclosure on a more frequent basis than annually?

Although not in a position to take a strong view regarding the frequency of disclosure, we support the CSA's efforts to standardize the disclosure protocol for commission usage. Any disclosure regime should be applied on a regular and consistent basis, in particular to the Boards, Trustees and other persons with oversight responsibilities for advisors. It is worth noting that the IMA's Level Two disclosure regime calls for semi-annual reporting on commission usage.

Question 14. What difficulties, if any, would an advisor face in making the disclosure in Part 4 of the Proposed Instrument?

Recognizing the need for proprietary and third party research to be treated equitably, the difficulty in disclosing client commissions lies in the opaque nature of proprietary commissions. Brokers providing such proprietary products have not taken measures to itemize their service offerings.

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 that they can be reasonably estimated?

Because "net" trades are not used to pay for research services or for straight agency execution, they do not fit into any of the 3 buckets outlined in Part 4.1 (c). If such commissions are to be disclosed it should be in an independent category separate from the original 3 commission categories.

<u>Additional Comments</u>

As referenced in our response to the SEC's request for comment prior to their final 2006 release, there is a tendency for advisors to place caps on the amount of independent research that is utilized in the investment decision-making process. Some advisors seem to believe that they must limit the amount of independent or discreetly priced research

that they acquire while they are not limited in the amount of proprietary, opaquely priced research that they receive from full-service brokers on a bundled basis. We feel that it would be helpful, and benefit the end investor, if the CSA would put in writing that no such cap exists or is warranted and that placing arbitrary percentages on any exposure to research is potentially harmful to the end investor.

Conclusion

Independent research is vital to the financial markets, in that it provides advisors with access to a wide variety of conflict-free thought and investment ideas. Soft dollar arrangements provide advisors with the framework that allows independent research providers to compete with full-service brokerage firms. We commend the CSA for recognizing the importance of this issue. However, as indicated in our response to Question 12 and our Additional Comments, we believe that any disclosure regime that emerges should treat proprietary research and independent research equitably.

We thank the CSA for the opportunity to comment on the Proposed Instrument and would be happy to provide further information or discuss these issues in greater detail in the future.

Very truly yours,

John Meserve
Director
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