INVESTMENT ADVISER
ASSOCIATION

April 8, 2008

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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

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and

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Re: Notice of Proposed National Instrument 23-102, Use of Client Brokerage Commissions as Payment for Order Execution Services or Research Services and Companion Policy 23-102CP

Dear Mr. Stevenson and Madame Beaudoin:

The Investment Adviser Association ("IAA") welcomes the opportunity to comment on the Canadian Securities Administrators' ("CSA") reproposal of National Instrument 23-

102 regarding the use of client brokerage commissions as payment for order execution services or research services.[1] The CSA issued this reproposal after requesting and considering comments on its initial soft dollar proposal in 2006.[2] The IAA submitted comments on the 2006 Instrument and incorporates those comments by reference.[3]

The IAA is a not-for-profit organization that exclusively represents the interests of investment adviser firms registered with the U.S. Securities and Exchange Commission ("SEC"). The IAA consists of more than 500 SEC-registered investment adviser firms that collectively manage in excess of $9 trillion U.S. in assets for a wide variety of institutional and individual clients, including pension plans, trusts, investment companies, endowments, foundations, and corporations. The IAA's membership includes Canadian-based investment advisory firms, as well as U.S.-based advisory firms that conduct investment advisory business in Canada, either through affiliates providing investment management services to Canadian clients or as sub-advisers to Canadian advisers. In addition, many of these global firms offer advisory services in other countries, including the United Kingdom.

We commend the CSA for considering these important issues and our previous comments to the Proposal. In particular, we commend the CSA for attempting to harmonize the definitions of research services and order execution services with those adopted in the U.S. and for streamlining the Proposal. Nevertheless, we continue to be concerned with some aspects of the Proposed Instrument and appreciate the opportunity to provide additional input. As discussed below, we strongly urge the CSA to: (i) reconsider its requirement to unbundle proprietary commissions into execution and other products and services; (ii) consider aligning its disclosure regime with that recently proposed by the SEC; (iii) further streamline the requirement for advisers to list all broker-dealers they use; and (iv) extend the effective date for the proposed disclosure rules, if not revised, to one year from the approval date.

I. The CSA Should Modify the Proposed Disclosure on Bundled Commissions

The IAA appreciates the CSA's desire to clarify the goods and services that may be acquired with client brokerage commissions and to increase accountability and transparency with respect to brokerage commissions. The IAA consistently has supported accurate and informative disclosure of client commissions for research and brokerage services so that

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[1] *Notice of Proposed National Instrument 23-102, Use of Client Brokerage Commissions as Payment for Order Execution Services or Research Services and Companion Policy 23-102CP*, 31 OSCB 489 (Jan. 11, 2008) ("Proposal" or "Proposed Instrument").

[2] *Notice of Proposed National Instrument 23-102, Use of Client Brokerage Commissions as Payment for Order Execution Services or Research ("Soft Dollar" Arrangements)*, 29 OSCB 5923 (July 21, 2006) ("2006 Instrument").

[3] *See* Letter from Valerie M. Baruch, Assistant General Counsel, IAA to Ontario Securities Commission, *et al.* re: Proposed NI 23-102, Use of Client Brokerage Commissions as Payment for Order Execution Services or Research (Nov. 1, 2006). Our comment letters are available under "Comments & Statements" on the IAA website at www.investmentadviser.org.

clients can be knowledgeable about how their commission dollars are being used. However, we have concerns with the CSA's proposed quantitative disclosure requirements.

Lack of Precision and Comparability for Clients

In the 2006 Instrument, the CSA proposed detailed requirements for advisers to disclose client-level and security-class-level disclosure.[4] We expressed significant concerns in our 2006 comment letter that the 2006 Instrument sought a type and level of disclosure that clients generally have not requested and that clients receiving such information in other jurisdictions have not appeared to find meaningful. The CSA acknowledged this difficulty in its response in this Proposal, stating, "*[d]ue to the lack of precision regarding costs for bundled services*, as well as timing differences between the trades that generate the commissions and the payment with those commissions for the goods and services, we agree that the detailed disclosure [proposed in 2006] would be difficult to make with any degree of accuracy."[5]

Nevertheless, the CSA reproposed a quantitative disclosure requirement that, while narrowed from the 2006 Instrument, would still require advisers to unbundle proprietary brokerage commissions. Specifically, Part 4.1(g) would require advisers to provide disclosure of, "on an aggregated basis, where the level of aggregation has been determined by the adviser, the total client brokerage commissions paid during the period reported upon, along with the adviser's reasonable estimate of the portion of those commissions that represents the amounts paid or accumulated to pay for goods and services other than order execution during that period." As we noted in 2006, and based on additional experience with the U.K. regulatory regime for brokerage commission disclosure, we strongly believe that such disclosure will be difficult to develop and would not provide meaningful information to clients.[6]

Advisers subject to U.K. Financial Services Authority rules have been seeking to comply with the U.K.'s Investment Management Association's ("IMA") Pension Fund Disclosure Code ("IMA Code") since mid-2006.[7] The IMA Code does not include a methodology for estimating research and execution costs, which are required to be disclosed. As a result, advisers have adopted varied and inconsistent methodologies. Among other

[4] As the CSA noted, commenters generally objected to the qualitative disclosure proposed in the 2006 Instrument as not providing meaningful information to clients and as potentially misleading or confusing.

[5] Proposal at 519 (emphasis added).

[6] *See* Question 2 of the Proposal (requesting information about the difficulties posed by the requirement).

[7] The IMA developed the IMA Code (2d. Ed., Mar. 2005) to increase transparency for "softing arrangements" (*see* http://www.investmentuk.org/news/standards/pfdc2.pdf). The FSA endorsed the IMA Code in Policy Statement 05/9 (July 2005), and FSA requirements appear in Code of Business Sourcebook 11.6.17. Level I of the IMA Code requires disclosure of a firm's brokerage policies, procedures, and control processes. Level II requires disclosure of, among other things, the amount that is used to pay for non-execution related services from the executing broker.

approaches, advisers may: (1) value what the research is worth and determine the rest of the commission cost is execution; (2) value what the execution is worth and determine the rest of the commission cost is research; or (3) estimate what the cost would be to reproduce the research.[8] This task is further complicated by the fact that these services are generally not available for purchase separately from a given broker in the market, and brokers are not obligated to provide cost information.

None of these methods produces reliable and comparable data for clients and may in fact confuse clients. As a result, advisers have been faced with significant costs and undertakings in order to comply with a disclosure regime that is not uniform, consistent, or reliable and that does not provide clients with disclosure that assists in assessing the adviser's execution quality or performance results. In addition, many clients do not typically seek this type of information from their advisers.

Even if advisers requested full-service broker-dealers *not* to provide their proprietary research along with execution services, those broker-dealers would not charge less in commission rates. Advisers may value a broker's research at a very low cost, while agreeing to pay a commission that is higher than a commission available via an electronic communication network. Advisers may place such orders because they value the execution services that the broker provides, such as working the order in an expedient and anonymous way, thereby helping the advisers satisfy their fiduciary duty to seek best execution for their clients.[9]

Further, as the CSA noted in the Proposal, disclosure in this area is imprecise because broker-dealers do not provide, and are not required to provide, any information related to the cost of the research and/or other products or services they provide. We recommend that, if the CSA determines to require advisers to estimate the cost of bundled proprietary brokerage commissions, it should also require broker-dealers to provide information to advisers regarding the costs of the associated research or other products and/or services provided along with the execution costs.

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[8] Under some of these methodologies, advisers may conduct polls of their traders and investment professionals in order to assess the execution quality of the broker-dealers utilized, as well as the relative quality of the research that may be provided by the broker-dealer. Other advisers may apply a formula to the commission costs based on an estimate of the relative value of the research or other products and/or services received. Other advisers may base the cost of the research and/or other products and services on the results of surveys of their broker-dealers seeking information on cost of the research and/or brokerage products or services. This latter methodology may require advisers to make estimates when a broker-dealer does not respond, which may often be the case.

[9] Advisers have a fiduciary obligation to seek the most favorable terms reasonably available under the circumstances for the execution of clients' securities transactions. An adviser considers the full range and quality of a broker's services in placing brokerage including, among other things, the value of research provided as well as execution capability, commission rate, financial responsibility, responsiveness to the money manager, liquidity, transparency, and capital commitment.

Investment Fund Disclosure

The CSA asserts that the requirement proposed in Part 4.1(g) is "relatively consistent" with that currently required to be made by investment funds to clients under National Instrument 81-106.[10] We respectfully disagree. Under NI 81-106, the notes to the funds' financial statements must disclose "to the extent the amount is ascertainable," the amount paid for soft dollar goods and services other than order execution. As discussed above, these amounts are not currently, and have not been, ascertainable due to the fact that these products and services are generally not available for purchase separately from a broker, and brokers are not obligated to provide cost information. Therefore, we understand that investment funds generally have not taken the approach that NI 81-106 disclosure requires "unbundling" proprietary brokerage commissions.

The CSA acknowledges this conclusion in its *Frequently Asked Questions on National Instrument 81-106*, where it states that, "[i]n cases where the investment fund cannot ascertain the value of the soft dollar portion, a statement should be included in the notes that the soft dollar portion is unascertainable."[11] At a minimum, we respectfully request the CSA to acknowledge this point in the adoption of NI 23-102.

Alternative Qualitative Disclosure

We urge the CSA to instead adopt a disclosure regime for brokerage commissions similar to that in the U.S. for advisers, where advisers provide meaningful information to their clients regarding the factors they consider in selecting brokers and determining the reasonableness of their commissions, as discussed below.

II. The CSA Should Adopt a Regulatory Regime Consistent with the SEC's Qualitative Disclosure Requirements

The CSA seeks comment in Question 3 as to whether the Proposed Instrument should allow an adviser to follow the disclosure requirements of another regulatory jurisdiction in place of the Proposed Instrument and whether the adviser should have to demonstrate that those requirements are, at a minimum, similar to the requirements in the Proposed Instrument. We submit that the Proposed Instrument should permit advisers to follow the disclosure requirements of the SEC in place of the Proposed Instrument.[12] In the alternative, the CSA should further harmonize its approach with that of the SEC.

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[10] *See* Proposal at 515. NI 81-106 *Investment Fund Continuous Disclosure* came into effect on June 1, 2005.

[11] FAQ B-5, *CSA Staff Notice 81-315, Frequently Asked Questions on National Instrument 81-106, Investment Fund Continuous Disclosure* (Nov. 25, 2005), available at http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part8/rule_20051125_81-315_faq-inv-fund-cd.jsp.

[12] The CSA could also use this approach to alleviate some of the burdens caused by the Proposal's indirectly imposing disclosure requirements on U.S. sub-advisers not otherwise subject to the rule.

As we commented in 2006, we respectfully suggest that investors would be better served by brokerage commission disclosure that supplies relevant qualitative information about an investment adviser's general trading practices, including the adviser's policy with respect to research and the way in which brokerage allocation decisions are made. A narrative disclosure format allows for a flexible disclosure regime that is informative and relevant for clients. For example, the SEC's current Form ADV Part II requires advisers to describe the factors considered in selecting brokers and determining the reasonableness of their commissions.[13] In addition, the IMA Code Level I Disclosure provides qualitative disclosure to clients regarding a manager's broker selection, broker review, identifying conflicts of interest in the manager's brokerage practices, and describing how the conflicts are managed and monitored.

The SEC's recently proposed amendments to the Form ADV Part II ("Part 2") reflect this flexible disclosure approach.[14] The SEC proposed qualitative disclosure requirements regarding advisers' soft dollar practices, including disclosure about any conflicts of interest they create and that advisers may have an incentive to select a broker-dealer based on their interest in receiving the soft dollar benefits, rather than on their clients' interest in receiving best execution.[15] The SEC did not require advisers to perform the burdensome and imprecise task of breaking down bundled commission costs to disclose the amount of the execution costs and other research and/or brokerage services.[16] We believe the current and proposed Form ADV disclosure regime clearly addresses the CSA's goal of increased transparency and accountability with respect to brokerage commission practices.

III. The CSA Should Further Streamline and Clarify the Proposal

In addition to the quantitative disclosure, we are concerned about the requirements set forth in Part 4.1(c) that would require disclosure to clients of all broker-dealers used and their products and services provided, separately identifying each affiliated entity and the types of

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[13] Item 12 of Form ADV Part II. Form ADV is available at http://www.sec.gov/about/forms/formadv.pdf. Part 1 of Form ADV is filed and available to the public electronically through the Investment Adviser Registration Depository (IARD) at http://www.sec.gov/IARD. Current Form ADV Part II is a written disclosure statement containing information about an investment adviser's background and business practices that is required to be delivered to each client or prospective client initially at the time of contract and offered annually.

[14] On March 3, 2008, the SEC proposed amendments to Form ADV Part 2. *See Amendments to Form ADV*, SEC Rel. IA-2711 (Mar. 3, 2008) ("Form ADV Proposal"), available at http://www.sec.gov/rules/proposed/2008/ia-2711.pdf. Comments on the proposal are due to the SEC by May 16, 2008.

[15] *See* Proposed Item 12 of Proposed Form ADV, Part 2A.

[16] SEC staff is considering proposed interpretive guidance this spring that will address U.S. mutual fund boards of directors' oversight of fund advisers' trading practices generally, including soft dollar issues. *See Remarks before the IA Week and the Investment Adviser Association 10th Annual IA Compliance Best Practices Summit 2008, Speech by Andrew Donohue, Director, Division of Investment Management, SEC* (Mar. 21, 2008), available at http://www.sec.gov/news/speech/2008/spch032108ajd.htm (stating the SEC's approach is "taking into consideration the fact that regulatory requirements need to be flexible enough to accommodate rapidly evolving market conditions and practices in the area of soft dollars.").

goods and services provided by each affiliated entity. While we appreciate the CSA's effort to narrow this request from the 2006 Instrument, we continue to believe that providing lengthy lists of broker-dealers and affiliated broker-dealers' "services" utilized in a year would only serve to unduly increase disclosure documents instead of allowing clients to focus on relevant information generally describing the services offered and the types of broker-dealers utilized.

Further, we appreciate the CSA's recognition that investment advisers would not be required to allocate benefits received with the client commissions to particular clients. However, we request further clarification of the CSA's statement in Companion Policy Part 4.1(3) that a specific order execution service or research service may benefit more than one client, and may not always "directly" benefit each particular client whose brokerage commissions were used as payment for the particular service. Specifically, we seek confirmation that "directly" does not infer an intangible benefit that the investment adviser may not be capable of identifying.

IV. If Adopted as Proposed, the CSA Should Extend the Effective Date to at Least One Year

We respectfully request the CSA reconsider its proposal to require disclosure of "unbundled" proprietary commissions. However, should the CSA determine to adopt this requirement, we believe a longer transition period than six months is needed. Advisers facing a new and complicated disclosure regime would need this time to develop and implement systems and revise procedures and disclosure. Accordingly, the CSA should extend the effective date of the Proposal to at least one year.

Conclusion

We respectfully request the CSA to continue a dialogue with regulators such as the SEC to harmonize rules and regulations with respect to client brokerage commissions affecting global asset managers that manage client assets through affiliates or through sub-advisory relationships. We continue to submit that meaningful *qualitative* disclosure will enable clients to adequately assess any potential conflicts of interest the adviser may face in managing the client's assets and the adviser's practices in this regard.

The IAA greatly appreciates your consideration of our comments on Proposed NI 23-102. Please do not hesitate to contact us if we may provide additional information or assistance to you regarding these matters.

Sincerely,

Monique S. Botkin

Senior Counsel