Chapter 6

Request for Comments

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

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

I. INTRODUCTION

We, the Canadian Securities Administrators (CSA), are publishing for comment proposed National Instrument 23-102 *Use of Client Brokerage Commissions as Payment for Order Execution Services or Research (“Soft Dollar” Arrangements)* (Proposed Instrument) and Companion Policy 23-102 CP (Proposed Policy). The comment period will end 90 days from the date of publication.

We seek to adopt the Proposed Instrument as a rule in each of British Columbia, Alberta, Manitoba, Nova Scotia, Ontario and Québec, as a Commission regulation in Saskatchewan and as a policy in each of the other jurisdictions represented by the CSA. The Proposed Policy would be adopted as a policy in each of the jurisdictions represented by the CSA.

II. BACKGROUND

The Current Regime

The current provisions describing the goods and services that may be acquired by advisers from or through dealers with brokerage commissions are Ontario Securities Commission (OSC) Policy 1.9 *Use by Dealers of Brokerage Commissions as Payment for Goods or Services other than Order Execution Services – (“Soft Dollar” Deals)* and the Autorité des marchés financiers (AMF) Policy Statement Q-20[1], of the same name (Existing Provisions). The Existing Provisions, which are virtually identical, specify that the only services acquired by managers that may be paid for with client brokerage commissions are “investment decision-making services” and “order execution services”, provided that these services benefit the manager’s beneficiaries, and not the manager. The Existing Provisions specify that these services may be provided directly by dealers or by third parties.

Concept Paper 23-402 Best Execution and Soft Dollar Arrangements

On February 4, 2005, staff of the Alberta Securities Commission, AMF, British Columbia Securities Commission, Manitoba Securities Commission and OSC published Concept Paper 23-402 *Best execution and soft dollar arrangements* (Concept Paper). The purpose of the Concept Paper was to set out a number of issues related to best execution and soft dollar arrangements for discussion and to obtain feedback. "Soft dollars" refers to the use by advisers of commission dollars to pay for trading-related goods or services, including incidental advice, research and analytical tools, in addition to paying for trade execution. In the Concept Paper, we specified that “soft dollar arrangements” includes both bundled services provided to advisers by dealers and allocations by advisers of part of the commissions paid to dealers to third parties.

An important concern relating to soft dollar arrangements noted in the Concept Paper was that they create potential conflicts of interest. This concern arises because of the incentives that such arrangements may create for advisers to place their interests ahead of their clients, including the incentive to direct trades to dealers for goods and services that benefit the advisers, and not their clients. The Concept Paper also noted that these potential conflicts of interest may obscure the advisers’ best execution obligations, as dealers may be selected for the soft dollar arrangements rather than for the quality of trade execution.

Other issues with these arrangements were also noted, for example: an adviser could potentially reduce costs in a poorly performing portfolio by allocating low commission trades to the portfolio but still use research and execution services paid for by other portfolios; where a mark-up is applied, it is difficult to assess whether a client has received best execution; and it is difficult to measure whether best execution is obtained because the commissions that are at the base of the arrangements sometimes include services from dealers that are bundled, and sometimes are for order execution only.

[1] AMF Policy Statement Q-20 gained the force of a rule in June 2003 through Section 100 of *An Act to amend the Securities Act* (S.Q. 2001, chapter 38).

Twenty-eight comment letters were received. These comments were summarized and published on December 16, 2005, in CSA Notice 23-303 *Update concerning Concept Paper 23-402 Best execution and soft dollar arrangements*.

While three respondents thought that soft dollar arrangements were not consistent with best execution, the majority believed they should be permitted. Some indicated that the benefits to such arrangements include the fact that they allow independent research providers to compete with full-service brokerage firms and ensure the availability of what some commenters viewed as more impartial research. Others noted that soft dollar arrangements allow smaller advisory firms to have access to a broader range of research services, and thus better compete with larger advisory firms. Some respondents echoed the concerns that conflicts of interest may arise for advisers that manage multiple client accounts or funds, as they may use one client's or fund's brokerage commissions to pay for services that benefit other clients or funds.

The overall response was that, while we should continue to permit client brokerage commissions to be used as payment for trading-related goods and services in addition to order execution, the Existing Provisions were too broad and subject to too much interpretation. Respondents noted that there should be more clarity and guidance regarding the types of goods and services that might be allowed under soft dollar arrangements. Almost all respondents agreed that additional disclosure was needed to increase accountability and transparency.

International Developments

Other jurisdictions have also focused on the issue of client commission arrangements in the past few years. In the United States, Section 28(e) of the Securities Exchange Act of 1934 (Exchange Act) provides a safe harbor that protects money managers from liability for a breach of fiduciary duty solely on the basis that they paid more than the lowest commission rate in order to receive brokerage and research services provided by a dealer. In order to be eligible for the safe harbor, money managers must determine in good faith that the amount of the commissions was reasonable in relation to the value of the brokerage and research services received, and the goods or services obtained must meet the broad statutory definitions of brokerage and research services provided under Section 28(e)(3). In October 2005, the Securities and Exchange Commission (SEC) published for comment an interpretive release (2005 Proposing Release)[2] to provide additional guidance. In the 2005 Proposing Release, the SEC narrowed its interpretation of the definitions for brokerage and research services, but did not address disclosure requirements regarding client brokerage commission arrangements. The SEC indicated in the 2005 Proposing Release that it would be providing additional guidance on disclosure requirements at some point in the foreseeable future. On July 18, 2006, the SEC published the final interpretive release[3] (2006 Release) that provides guidance on money managers' use of client commissions to pay for brokerage and research services.

In the United Kingdom, the Financial Services Authority (FSA) adopted final rules on July 22, 2005, in conjunction with issuing policy statement PS 05/9.[4] The FSA final rules describe "execution" and "research" products and services eligible for payment via client brokerage commissions, and specify a number of "non-permitted" services that must be acquired using the investment managers' own funds. The policy statement acknowledges that some products and services may be permitted or non-permitted, depending on how they are used by the investment manager. The FSA final rules also establish certain high-level disclosure requirements, and state that the FSA will have regard to the extent to which investment managers adopt disclosure standards developed by industry (such as the standards set out by the Investment Management Association (IMA)).

Both the SEC's and FSA's initiatives were discussed in the Concept Paper. In the comments received, the majority of respondents encouraged us to consider the approaches taken in the U.S. and the U.K., and to continue to monitor developments in these jurisdictions. We have taken into account the SEC and FSA approaches in developing this proposal and believe that this proposal is largely consistent with these approaches.

III. SUBSTANCE AND PURPOSE OF THE PROPOSED INSTRUMENT AND PROPOSED POLICY

Purpose of the Proposed Instrument and Proposed Policy

There are fundamental existing obligations for a registered dealer or an adviser to act fairly, honestly, and in good faith with their clients. In addition, securities legislation in some jurisdictions requires managers of mutual funds to also exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances.

The Proposed Instrument provides a specific framework for the use of client brokerage commissions by advisers. It clarifies the broad characteristics of the goods and services that may be acquired with these commissions and also prescribes the advisers' disclosure obligations when using brokerage commissions as payment for these goods and services.

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2 Exchange Act Release No. 34-52635 (October 19, 2005).

3 Exchange Act Release No. 34-54165 (July 18, 2006). In this release, the SEC is also soliciting further comment on client commission arrangements under section 28(e) of the Exchange Act.

4 U.K. Financial Services Authority, Policy Statement 05/9, Bundled Brokerage and Soft Commission Arrangements: Feedback on CP 05/5 and Final Rules (July 2005) (FSA Final Rules). Note that these rules apply only to equity trades and not to fixed income trades.

The Proposed Policy gives additional guidance regarding the types of goods and services that may be obtained with client brokerage commissions, as well as non-permitted goods and services. It also gives guidance on the disclosure that would be considered acceptable to meet the requirements of the Proposed Instrument.

Discussion of the Proposed Instrument and Proposed Policy

In this Notice, discussion of the Proposed Instrument and Proposed Policy is divided into the following topics: application of the Proposed Instrument; the framework for client brokerage commission practices; the definitions of order execution services and research; and the disclosure of client brokerage commission practices.

Application of the Proposed Instrument

Section 2.1 of the Proposed Instrument limits the application of the Proposed Instrument to transactions where brokerage commissions have been charged by a dealer. The reference to "brokerage commissions" includes any commission or similar transaction-based fee. This would therefore also include transactions where the commissions are technically zero, but where a fee can be separately broken out.

We have taken the view that the Proposed Instrument can be applied to transactions in all securities, so long as brokerage commissions are charged. We note that the SEC has taken a slightly narrower view in its 2006 Release[5] by indicating that the safe harbor provided under Section 28(e) applies to client commissions on agency transactions and fees on certain riskless principal transactions, and not to fixed-income trades that are not executed on an agency basis, principal trades (except for certain riskless principal trades), or other instruments traded net with no explicit commissions. The FSA, however, has taken an even narrower view. In its Final Rules, it has restricted the application of the rules to shares and certain related instruments (such as options and warrants). It has stated that its Final Rules do not apply to fixed-income investments, but noted that if the same conflicts of interest were found to be inherent in the fixed-income market, the FSA would revisit its position.[6] We specifically request comment on whether the Proposed Instrument should be restricted to transactions where there is an independent pricing mechanism, for example, for transactions in exchange-traded securities.

We have also provided clarification in section 2.1 of the Proposed Policy that the adviser requirements in the Proposed Instrument apply equally to registered advisers and registered dealers that perform advisory functions but are exempt from registration as advisers.

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?

The Framework for Client Brokerage Commission Practices

The Proposed Instrument establishes the general parameters for: (1) advisers that enter into any arrangements to use brokerage commissions, or any portion thereof, as payment for order execution services or research; and (2) registered dealers that receive commissions as payment for order execution services or research provided to the advisers.

a) Advisers

Section 3.1 of the Proposed Instrument indicates that advisers may not enter into any arrangements to use brokerage commissions, or any portion thereof, as payment for goods and services other than order execution services or research. It also reinforces the overriding requirement that advisers must act in the best interests of their clients by ensuring that: the order execution services or research paid for with client commissions benefit the clients; the research received adds value to investment or trading decisions; and the brokerage commissions paid are reasonable in relation to the value of goods and services received. Section 4.1(1) of the Proposed Policy clarifies that the arrangements that advisers may enter regarding the use of client commissions may be formal or informal, and that informal arrangements would include those relating to the receipt of such goods and services from a dealer offering proprietary, bundled services.

Section 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

5 In footnote 27 of the 2006 Release.

6 The FSA's basis for limiting the Final Rules to shares and related investments was discussed in Consultation Paper 05/5 - *Bundled brokerage and soft commission arrangements: proposed rules.*

a connection between the client(s) whose brokerage commissions were used as payment for goods and services and the benefits received.

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?

b) Registered Dealers

While advisers have the responsibility to act in the best interests of their clients, registered dealers must also ensure that commissions received from advisers on brokerage transactions are only used as payment for goods and services that meet the definition of order execution services or research. A registered dealer's obligations are set out in section 3.2 of the Proposed Instrument.

Subsection 4.2 of the Proposed Policy also indicates that the Proposed Instrument does not restrict a registered dealer from forwarding to a third party, on the instructions of an adviser, any portion of the commissions it has charged on brokerage transactions to pay for order execution services or research provided to the adviser by that third party. We believe such practices should be permitted in order to provide flexibility and promote the use of independent research. Additionally, we agree with commenters to the Concept Paper that there should be no difference in eligibility of these services based on who provided them.[7]

<u>Definitions of order execution services and research</u>

The Proposed Instrument sets out the definitions of order execution services and research. The definitions include a description of the general characteristics of goods and services that qualify as order execution services or research.

The Proposed Policy provides further explanation of the definitions and provides guidance on the types of goods and services that may be paid for with brokerage commissions. A broad range of goods and services may be considered, regardless of form. The Proposed Policy reinforces that an adviser's responsibilities include determining whether a good or service, or a portion thereof, may be paid for with brokerage commissions, and to ensure both that the good or service meets the definition of order execution services or research and that it benefits the client(s).

a) Order execution services

Part 1 of the Proposed Instrument defines order execution services to include order execution, as well as goods and services that are directly related to order execution. Subsection 3.2(1) of the Proposed Policy clarifies that, for the purposes of the Instrument, the term "order execution", as opposed to "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.

Section 3.2 of the Proposed Policy clarifies that goods and services that are directly related to order execution are those that are essential to the arranging and conclusion of the securities transactions that generated the commissions. The Proposed Policy includes a temporal limitation, similar to those adopted by the SEC and FSA, to help describe the goods and services received by an adviser that are integral to the execution process. As a result, such goods and services provided between the point at which an adviser makes an investment or trading decision and the point at which the resulting securities transaction is concluded would generally be considered order execution services. The conclusion of the resulting transaction would occur at the point that settlement is completed. Therefore, order execution services could include custody, clearing and settlement services.

Subsection 3.2(3) of the Proposed Policy provides examples of goods and services that are generally considered to be order execution services including trading advice, algorithmic trading software, and raw market data to the extent it assists in the execution of orders.

We note that there has been some debate in other jurisdictions regarding whether order management systems (OMSs) should be considered order execution services (OMSs may assist with functions such as order entry and routing, messaging, execution tracking, order inquiry, recordkeeping and supervision). In the 2006 Release, the SEC stated that certain functionality provided through OMSs may be eligible brokerage or research. The FSA's position is that these systems may be paid for with client brokerage commissions to the extent they are used for purposes that are directly related to order execution, and that provide benefit to the clients. Given the many different uses of OMSs, we are specifically requesting comment on this issue.

[7] We noted that the FSA, in its Final Rules, did not place any restrictions on whether the goods and services for which commissions were used as payment are provided by the registered dealer or by a third party. Similarly, in its 2006 Release, the SEC also permits client commissions to be used as payment for goods and services provided by a third party.

We also noted that the FSA has taken the position that post-trade analytics would not be considered to be order execution services as they are not sufficiently related to the execution of orders on a client's behalf, and they do not fall within similar temporal limitations. In its 2006 Release, the SEC stated that, to the extent that pre-trade and post-trade analytics are used in the investment decision-making process, they may be obtained with client commissions, and therefore would be treated as mixed-use products. Similarly, we propose to exclude post-trade analytics from goods and services that may be considered order execution services; however, post-trade analytics could be considered to be research to the extent they meet the definition of research, as discussed below.

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".**

Question 4:

> **Should post-trade analytics be considered order execution services? If so, why?**

b) Research

The Proposed Instrument defines research as advice, analyses or reports and indicates the general subject matter that these goods and services should contain. In Part 3 of the Proposed Instrument, there are also requirements relating to the adviser's responsibility to ensure the research adds value to investment or trading decisions. Section 3.3 of the Proposed Policy provides further clarification.

We propose that, in order to add value to an investment or trading decision, research should include original thought and the expression of reasoning or knowledge. For this reason, information or conclusions that are commonly known or self-evident, that are simply a restatement or repackaging of previously stated information or conclusions, or information and data that have not been analyzed and manipulated in arriving at meaningful conclusions do not contain original thought, and may not reflect the expression of reasoning or knowledge. These would therefore not be considered research that may be paid for with client brokerage commissions. These views are consistent with those expressed by the SEC and FSA in their 2006 Release and Final Rules, respectively.[8] It is our view that to be permitted research, it would also have to be provided before an adviser makes an investment or trading decision, in order to link the research to order execution.

Subsection 3.3(2) of the Proposed Policy includes examples of the goods and services that we would generally consider to be research for the purposes of the Proposed Instrument. One of these items is market data, if it has been analyzed or manipulated to arrive at meaningful conclusions. Therefore, raw market data would not be considered to be research (although it may, in appropriate circumstances, be considered to be order execution services) as it has not been analyzed or manipulated and would therefore not contain original thought or the expression of reasoning or knowledge.

We note that the FSA, in its Final Rules, took the position that raw market data that has not been analyzed or manipulated cannot be considered research (the FSA's position that raw market data may be considered for inclusion in order execution services is consistent with our position). The SEC, however, took the view in the 2006 Release that all market data (including raw market data) such as stock quotes, last sale prices and trading volumes, contains aggregations of information on a current basis related to the subject matter identified in Section 28(e), and therefore contains sufficient substantive content to be considered research.

Another item we believe should be considered to be research under the Proposed Instrument is post-trade analytics from prior transactions in securities, if such analytics help inform subsequent investment or trading decisions. Our view is consistent with the FSA and SEC positions that post-trade analytics may, in some circumstances, be classified as research.

Another issue raised by the SEC in their 2005 Proposing Release related to proxy-voting services. Specifically, the SEC asked whether proxy-voting services are being paid for with client commissions. It had previously found that client commissions were being misused as payment for *electronic* proxy-voting services, as advisers had purchased software to administer the proxy-voting function with these commissions.[9] The responses to the 2005 Proposing Release showed that U.S. market participants, while acknowledging that the proxy-voting agent function is an administrative function that must be paid by them with their own

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8 The definition of research in the Proposed Instrument is similar to the definition in the SEC safe harbor (the FSA interprets research in a similar manner, in its Final Rules, provided it is directly relevant and used to assist in the management of investments on behalf of customers). The guidance provided in the Proposed Policy takes into consideration the interpretations and guidance provided by both the SEC in its 2005 Proposing Release, confirmed in the 2006 Release, and by the FSA in its Final Rules. Differences in the interpretation of the types of goods and services that may be considered to be research are highlighted in this section.

9 Based on data from the *Inspection Report on the Soft Dollar Practices, of Broker-Dealers, Investment Advisers and Mutual Funds*, prepared by the SEC's Office of Compliance, Inspections and Examinations, dated September 22, 1998.

funds, considered a portion of the proxy-voting services as a research function[10], eligible to be paid for with client commission. In its 2006 Release, the SEC clarified that proxy-voting services would be eligible to be paid for with client commission to the extent that they are used to make investment decisions. We seek comment regarding the use of client brokerage commissions to pay for proxy-voting services below.

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.?

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?

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?

c) Mixed-use goods and services

Section 3.4 of the Proposed Policy provides guidance regarding mixed-use items, which are goods and services that contain some elements that may meet the definitions of order execution services or research, and other elements that either do not meet the definitions or that would not meet the requirements of Part 3 of the Instrument (such as the previously-mentioned OMSs, post-trade analytics, and proxy-voting services). Specifically, it indicates that, where goods and services paid for with brokerage commissions have a mixed use, the adviser should make a reasonable allocation of the amounts paid according to their use, and should keep adequate books and records concerning these allocations. This would help to ensure that the brokerage commissions paid by clients are not used to pay for the components of such items that did not directly benefit them. Furthermore, the portion of a good or service that does not benefit clients should be paid for with the adviser's own funds. This approach is consistent with the SEC's views regarding mixed-use items. We note that the FSA did not specifically address the permissibility of mixed-use goods and services in its Final Rules, but it appears that the FSA's Final Rules do not restrict the use of brokerage commissions to pay for mixed-use goods and services.

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)?

d) Non-permitted goods and services

Section 3.5 of the Proposed Policy provides examples of goods and services that, due to their characteristics and the lack of a clear connection to specific securities transactions, are not considered order execution services or research for the purposes of the Proposed Instrument. These are goods and services that are primarily related to the operation of an adviser's business.

Included as non-permitted items are seminars, as well as mass-marketed or publicly-available information or publications. Similar to the position reflected in the FSA's Final Rules, we indicate in the Proposed Policy that these items are not sufficiently linked to an adviser's investment or trading decisions, or the execution of orders, to be permissible. In the 2006 Release, however, SEC staff indicated that seminars, if they contain the expression of reasoning or knowledge and relate to the subject matter of Section 28(e), could be permitted as research. With respect to mass-marketed and or publicly available information or publications, SEC staff clarified that certain financial newsletters and trade journals intended to serve the interests of a narrow audience could be research if they relate to the subject matter of Section 28(e), however, they stated that mass-marketed publications will not be eligible to be paid for with client commissions.

[10] See 2006 Release at page 37.

Question 9:

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

e) General Considerations

The Proposed Policy provides examples of some of the most commonly encountered goods and services that, in our view, may be considered order execution services or research and those that are non-permitted. However, the examples given are not exhaustive. In the responses received to the Concept Paper, we were provided with other examples of goods that should not be permitted.

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?

<u>Disclosure of Client Brokerage Commission Practices</u>

Part 4 of the Proposed Instrument sets out the initial and periodic disclosure to be made to clients by advisers that enter into arrangements where brokerage commissions, or any portion thereof, are used as payment for goods and services other than order execution.

The Proposed Instrument requires the disclosure to be provided to each of its clients on an initial basis, and at least annually. Section 5.1 of the Proposed Policy clarifies that the initial disclosure should be made before an adviser starts conducting business with its clients, and that periodic disclosure should be made at least on an annual basis. Section 5.3 of the Proposed Policy also clarifies that the form of disclosure may be determined by the adviser based on the needs of its clients, but that the disclosure should be provided in conjunction with other initial and periodic disclosure relating to the management and performance of the account, portfolio, etc. Some examples are provided.

Question 11:

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

Section 4.1 of the Proposed Instrument also requires the adviser to make adequate disclosure of the following: 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, and the general types of these goods and services provided by each of the dealers and third parties (for example, algorithmic trading software, research reports, trading advice, etc.).

In addition, certain disclosures should be made relating to the amounts of commissions paid by the adviser during the period reported upon. In subsections 4.1(b) through (d) of the Proposed Instrument, advisers are required to disclose to each client the total brokerage commissions, broken down by security class (for example, equity, options, etc.), that were paid by advisers on behalf of each client and on behalf of all clients, for comparison purposes. Advisers are also required to separate the trades as follows: trades where clients receive only order execution from dealers and no other services; trades where they receive bundled services; and trades where part of the commission paid is directed to third parties. The latter category is further sub-divided into third-party research, other third-party services, and the dealers' portion. The advisers must make reasonable estimates, for each client and for all clients in aggregate, of the brokerage commissions for each one of these categories of trades as a percentage of the total brokerage commissions paid and disclose these percentages to their clients. In addition, advisers are also required to estimate and disclose the weighted average brokerage commission per unit of security corresponding to the commissions underlying each of those percentages. Additional guidance is provided in the Proposed Policy regarding the different categories of order execution identified in the disclosure and the method that should be used for calculating the weighted average.

We are of the view that disclosure of these amounts, percentages and weighted averages would increase transparency regarding the brokerage commissions paid on the clients' behalf by helping them to better assess the uses of brokerage commissions by the advisers. This should also lead to greater accountability on the part of the adviser relating to the use of these commissions. Since one of the main reasons given in support of soft dollar arrangements is that such arrangements facilitate independent research, we are also of the view that the separate disclosure of the amount of commissions forwarded by dealers to third parties for research would be useful information.

To further increase the level of transparency and accountability, in subsection 4.1(2) of the Proposed Instrument, the adviser is required to maintain certain additional details regarding each specific good and service received for which payment was made with brokerage commissions, and to make the details available upon request to its clients. We also believe the adviser should maintain these details relating to activity over the most recent five years.

We are considering whether there should be additional disclosure requirements for trades done on a "net" basis, where the transaction fee paid to the dealer is embedded in the price of the securities (for example, for trades done on a principal basis). We acknowledge the complexities involved in calculating the costs associated with a trade executed on a net basis, as well as the fact that advisers may take different approaches in estimating these costs. We note that in the U.K., the IMA's disclosure requirements in this regard are limited to the disclosure of the percentage of trades executed without explicit commissions, and no further allocation of the implicit costs is made. We are requesting comment on the appropriate disclosure requirements for trades executed on a net basis.

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?

Question 13:

Should periodic disclosure be required on a more frequent basis than annually?

Question 14:

What difficulties, if any, would an adviser face in making the disclosure under Part 4 of the Proposed Instrument?

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?

IV. NO TRANSITION PERIOD

We are not proposing that there be a transition period in light of the fact that the Existing Provisions are in place, and that the Proposed Instrument and Proposed Policy provide additional guidance. Additionally, there will be a period of time between the adoption of any final instrument and its effective date, during which time advisers may make any needed modifications to policies, practices and arrangements, with the most significant modifications likely relating to the increased disclosure requirements.

V. SPECIFIC REQUESTS FOR COMMENTS

In summary, we specifically request comment on the following issues:

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?

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?

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".

Question 4:

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

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.?

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?

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?

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)?

Question 9:

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

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?

Question 11:

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

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?

Question 13:

Should periodic disclosure be required on a more frequent basis than annually?

Question 14:

What difficulties, if any, would an adviser face in making the disclosure under Part 4 of the Proposed Instrument?

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?

VI. AUTHORITY FOR THE PROPOSED INSTRUMENT

In those jurisdictions in which the Proposed Instrument is to be adopted as a rule or regulation, the securities legislation in each of those jurisdictions provides the securities regulatory authority with rule-making or regulation-making authority in respect of the subject matter of the Proposed Instrument.

In Ontario, the Proposed Instrument is being made under the following provisions of the *Securities Act* (Ontario) (Act):

- Paragraph 2(i) of subsection 143(1) of the Act allows the Commission to make rules in respect of standards of practice and business conduct of registrants in dealing with their customers and clients, and prospective customers and clients.

- Paragraph 2(ii) of subsection 143(1) of the Act allows the Commission to make rules in respect of requirements that are advisable for the prevention or regulation of conflicts of interest.

- Paragraph 7 of subsection 143(1) of the Act allows the Commission to make rules prescribing requirements in respect of the disclosure or furnishing of information to the public or the Commission by registrants.

VII. RELATED INSTRUMENTS

The Proposed Instrument and Proposed Policy are related to the Existing Provisions. The AMF and OSC intend to revoke the Existing Provisions and to replace them with the Proposed Instrument and the Proposed Policy, if and when adopted. The revocation of the Existing Provisions is not intended to take effect until the effective date of the Proposed Instrument.

VIII. ALTERNATIVES CONSIDERED AND ANTICIPATED COSTS AND BENEFITS

The alternatives considered, and the anticipated costs and benefits of implementing the Proposed Instrument, are discussed in the cost-benefit analysis entitled *Cost-Benefit Analysis: Use of Client Brokerage Commissions as Payment for Order Execution Services and Research*. The cost-benefit analysis has been published together with this Notice and is included as Appendix “A”.

IX. UNPUBLISHED MATERIALS

In developing the Proposed Instrument, we have not relied on any significant unpublished study, report, or other material.

X. COMMENTS AND QUESTIONS

Interested parties are invited to make written submissions with respect to the Proposed Instrument, Proposed Policy, and the specific questions set out in this notice. Please submit your comments in writing before October 19, 2006.

Submissions should be sent to all securities regulatory authorities listed below in care of the OSC, in duplicate, as indicated below:

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

Submissions should also be addressed to the Autorité des marchés financiers (Québec) as follows:

Madame Anne-Marie Beaudoin
Directrice du secrétariat
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, Tour de la Bourse
Montréal (Québec) H4Z 1G3
Telephone: 514-940-2199 ext. 2511
Fax: 514-864-6381
e-mail: consultation-en-cours@lautorite.qc.ca

A diskette containing the submissions should also be submitted. As securities legislation in certain provinces requires a summary of written comments received during the comment period be published, confidentiality of submissions cannot be maintained.

Questions may be referred to:

Cindy Petlock
Ontario Securities Commission
(416) 593-2351

Susan Greenglass
Ontario Securities Commission
(416) 593-8140

Ruxandra Smith
Ontario Securities Commission
(416) 593-2317

Tony Wong
British Columbia Securities Commission
(604) 899-6764

Ashlyn D'Aoust
Alberta Securities Commission
(403) 355-4347

Doug Brown
Manitoba Securities Commission
(204) 945-0605

Serge Boisvert
Autorité des marchés financiers
(514) 395-0558 x4358

July 21, 2006

APPENDIX A

PROPOSED NATIONAL INSTRUMENT 23-102 USE OF CLIENT BROKERAGE COMMISSIONS AS PAYMENT FOR ORDER EXECUTION SERVICES OR RESEARCH COST-BENEFIT ANALYSIS

Introduction

The Ontario Securities Commission (OSC) is committed to delivering cost-effective regulation. One of the principles 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"[1].

We perform a cost-benefit analysis when we are considering significant policy initiatives. This identifies the intended and unintended economic effects of a regulatory proposal, and ensures that we take them into account when proposing new regulations.

This cost-benefit analysis discusses the regulatory issues relating to the use of client brokerage commissions as payment for execution services or research, and the benefits and costs of various options for addressing these issues.

Soft dollar arrangements

In the course of managing their clients' money, advisers and portfolio managers (referred to here as advisers) often use a portion of the brokerage commissions to buy investment management-related goods and services. These purchases can take two forms: where the dealer combines other products, such as in-house research, with trade execution; and where the adviser directs a portion of the commission amount to a third party. In this analysis, "soft dollars" refers to both the bundling of dealer goods and services with trade execution and to payments to third-parties.

If trading commissions are used to pay for goods and services, other than trade execution, the investor does not have complete information about the decisions made by the adviser. The investor's inability to effectively monitor how the adviser spends their money results in a principal-agent problem. The inherent conflicts of interest can create incentives for advisers to make decisions that may not be in the best interest of their clients. More specifically:

- Advisers may over-consume goods and services acquired with commission payments. These items may be acquired for an excessive price and/or in excessive quantities and may not benefit the client.
- Advisers may place trades or make investment decisions so as to maintain soft dollar relationships at the expense of their best execution obligations.
- Advisers with multiple clients may use commissions generated by one client to pay for services that benefit another.

From a theoretical perspective, bundling goods or services can generate economic benefits.[2] For example, combining goods or services can allow for economies of scope in their production, resulting in the combined price being lower that the price of each individual product. From the purchaser's perspective it can be cheaper to buy a combined product as opposed to separately finding each individual part. Also, bundled products can result in more efficiently set prices that reflect the value different purchasers are willing to pay. However, there is no information available about what the prices for investment management related goods and services would be in an un-bundled environment. Without that comparison it is difficult to assess if these theoretical benefits do occur.

The most frequently mentioned benefit of third-party payments is that they support independent research providers. It is argued that soft-dollar arrangements make it easier for research providers to gain access to advisers and so result in lower barriers to entry than would otherwise exist. This results in more research providers and greater competition amongst them. Increased choice and better quality research enables advisers to make better investment decisions. Those better decisions and the associated increased investment return will ultimately benefit investors.

The use of trading commissions to purchase goods and services other than trade execution effectively lowers the cost of market entry for advisers. This should encourage market entrants and increase competition between advisors. However, the demand for items such as market data and research reports is far more predictable than the demand for trade execution. The economic justification for using trading commissions to pay for such items is therefore questionable. Making that link may encourage advisers to trade excessively in order to receive the bundled or third-party goods and services.

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1 *Securities Act*, RSO 1990, c. S. 5, 2.1(6).

2 Financial Services Authority, CP176: Bundled brokerage and Soft Commission Arrangements, April 2003, pg 19-19.

The scope of the issue

Based on research by Greenwich Associates and IDA data, the value of Canadian soft dollar commissions in 2004 is estimated to have been approximately $300 million, with $61 million of that going to third parties[3].

The Greenwich research also shows a slight downward trend in the use of commission payments for third-party goods and services. While some firms are ending the practice completely, such decisions have been limited to extremely large portfolio management firms that can develop in-house research capabilities.

The key stakeholders in soft dollar arrangements are:

- Advisory firms - across Canada there are approximately 805 firms registered to provide investment management services to investors[4]. Not all of these firms will have arrangements to direct commissions to third-parties but a much higher proportion would receive dealer bundled goods and services[5].

- Investment dealers - as of the third quarter of 2005 there were 201 investment dealers in Canada[6]. Dealers will offer their clients bundled proprietary goods and the option of directing commission payments to third-party providers.

- Investors who use an adviser to manage their portfolio.

- Vendors of research or other services who receive payment for their products through soft dollar arrangements with dealers.

Regulatory concerns

Ontario currently has a policy[7] and Quebec[8] a rule that provide guidelines regarding soft dollar arrangements and their disclosure. It is believed that the current situation does not provide adequate clarity to participants and is not sufficient to protect investors from the inherent conflicts of interest. The following are of particular regulatory concern:

1. Regulators could be doing more to protect investors. Soft dollar arrangements can adversely affect investors, who may not even be aware of such practices. Current disclosure requirements do not allow investors to monitor the use of such arrangements and ensure they are getting fair value for their brokerage commissions.

2. Between 2003 and 2005, the OSC found deficiencies with 39% of the firms reviewed that used commissions to purchase third-party products.[9]

3. Requirements in Canada have not been updated as they have in the other capital markets Canada interacts with the most (i.e. the U.S.A. and United Kingdom).

4. The responses to Concept Paper 23-402 *Best execution and soft dollar arrangements* showed that existing requirements are not clear about what can and cannot be purchased with soft dollar commissions. OSC staff often receive inquiries from market participants about permitted goods and services.

5. Policies are not specifically enforceable like rules so there is no guarantee that advisers are following the guidelines and providing proper disclosure to their clients.

6. Within Canada there are no harmonized rules for using soft dollars or disclosing those arrangements.

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3 Greenwich Associates 2005 survey found that about 54% of commissions went to bundling and 11% to soft dollars (Greenwich Associates, Canadian Equity Market Trends – Statistical Supplement, June 2005). According to IDA statistics, total equity trading commission for dealers in 2005 was $554 million (Investment Dealers Association of Canada, securities Industry Performance, Q4 2005).

4 This figure represents the number of firms in National Registration Database (NRD) that are registered in an adviser category. Not all of these firms will be portfolio managers; some will just be investment counsel. The NRD information was extracted in January 2006.

5 This is based upon anecdotal evidence and Greenwich's research that shows that bundled goods and services are far more prevalent (54% of commissions allocated for bundled services as opposed to 11% for third-party research).

6 Investment Dealers Association of Canada, Securities Industry Performance, Fourth Quarter 2005.

7 OSC Policy 1.9 *Use by Dealers of Brokerage Commission as Payment of goods and Services other than Order Execution Services*.

8 Policy Statement Q-20 *Use by Dealers of Brokerage Commission as Payment of goods and Services other than Order Execution Services* (which became a rule in June 2003).

9 From April 2003 until March 2005, the OSC performed compliance reviews of 47 firms registered as investment counsel/portfolio managers (ICPM). 18 of those firms had soft dollar arrangements to purchase third-party goods and services. Of those, deficiencies were found at seven firms.

7. There are inconsistencies between the disclosure of brokerage commission practices for mutual funds and other managed investments.

Goals of this policy initiative

The policy initiative on client brokerage commissions has four goals:

1. To provide investors with more information about their adviser's use of soft dollar commissions.

2. To harmonize the rules for goods and services that can be purchased with client commission across the CSA and take into account international developments.

3. To clarify which goods and services can be acquired by advisers with client commissions and to assess their true management expense.

4. To increase confidence that commissions are ultimately benefiting those that pay them.

This should result in fewer soft dollar issues identified in compliance reviews, fewer inquiries from market participants about permitted goods and services, and better disclosure for investors.

Four options

There are four options for addressing soft dollars:

1. Maintain the status quo

2. Update the current requirements

3. Ban the practice

4. Reformulate the current requirements into a National Instrument

1. Maintain the status quo

Ontario could continue to maintain its policy, and Quebec its regulation, on soft dollars. Other jurisdictions would continue to look to these requirements for guidance.

Costs

- Does not address the potential for conflicts of interest. A continuing lack of meaningful transparency means investors are unable to effectively monitor their adviser's use of brokerage commissions to pay for investment management goods and services.

- Perpetuates uncertainty about the appropriate uses of soft dollars.

- Canada would fall further out of step with the international markets it most often interacts with, namely the U.S.A. and the United Kingdom. This could become a competitive disadvantage for Canada's capital markets if other jurisdictions are seen to have tighter controls on the use of brokerage commissions. Canadian investment managers may be less able to attract international investors.

Benefits

- No additional costs for dealers and advisers.

2. Update current requirements

This involves updating and clarifying the list of permitted goods and services under the current Ontario policy and Quebec rule. The revised requirements would also include guidelines for disclosure that should be provided to clients about how their brokerage commissions are spent. There are no guarantees that other jurisdictions will adopt the revised requirements and so there may not be increased harmonisation across the CSA. In Ontario, there is little to guarantee compliance by all advisers and dealers as the revised policy would remain a guideline and would not have the force of law.

To ensure compliance with the new requirements, advisers and dealers would have to review existing soft dollar arrangements and ensure that any goods and services they buy or provide are permitted. Most advisers have a list of services that can be acquired through the use of soft dollar commissions. This list is usually maintained by the firm's compliance staff and/or management. Similarly, dealers have lists of approved services that can be offered as part of a soft dollar arrangement. They would also need to ensure they comply with the new disclosure requirements.

Costs

- Production and distribution of documentation for advisers to provide to their clients to comply with the enhanced disclosure requirements. The current Ontario and Quebec requirements state that, upon request, advisers should provide to clients the names of research providers from whom research was acquired with soft dollars in the last fiscal year and a summary of those goods and services. The proposed instrument requires some general annual disclosure (similar to that currently set out in OSC Policy 1.9 and AMF Policy Statement Q-20) in place, but adds the following components:

  - The total brokerage commissions paid during the period, for each class of security, and for each client's account or portfolio.

  - A reasonable estimate of the percentage of those commissions that represent order execution only, order execution bundled with proprietary services offered by the dealer, and order execution involving a portion of the commission payment being directed to a third-party.

  - For third party payments, a reasonable estimate of the proportion directed to research providers, directed to other third-party vendors, and retained by the dealer(s).

- This increased disclosure standard will likely 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 required information should be available to the advisor and the necessary changes would be limited to how that information is stored and manipulated. The ongoing cost of producing, printing, and mailing the disclosure will be mitigated if changes are made initially to how the information is collected.

- Dealers and advisers would have to review their current use of soft dollar commissions against the proposed instrument and its companion policy. The FSA estimates that in the U.K., a review would require six days of a compliance officer's time and one day of a lawyer's time.[10] We expect that a review would take a similar amount of time for Canadian dealers and advisers, resulting in an estimated one-time cost of about $3 million. Table 1 below shows the breakdown of this cost.

Table 1	
Average number of days worked	252
Average salary of compliance officer	$77,000[11]
Estimated effort	6 days
Average salary of legal counsel	$124,000[12]
Estimated effort	1 day
Average senior management salary	$110,000
Estimated effort	1 day
Estimated number of affected firms (dealers and advisers)[13]	1,006
Estimated cost per firm	$2,800
Estimated industry cost ($3,000 * 1,006 firms)	$2.8 million

- In Ontario and Quebec, most dealers and advisers are already monitoring compliance with the existing requirements. Dealers and advisers in other jurisdictions are likely to be familiar with the current guidelines and have some policies and procedures in place. The additional ongoing cost of monitoring compliance against the updated requirements would likely be quite small.

10 OXERA, 2003, page 18. Although there are difference between the proposed instrument and the FSA's proposal we believe that this is a good estimate of the average effort required to review existing soft dollar arrangements.

11 The estimates for compliance officer and management salaries are based upon discussions with human resources consultants familiar with the employment market for compliance officials.

12 This is based upon estimates of salaries paid to experienced legal professionals in the regulatory community.

13 We have assumed that all the 201 dealers and 805 adviser firms have soft dollar arrangements. We expect this to be a high-end estimate of industry costs as not all firm have soft dollar arrangements involving third-parties.

- Some contracts between dealers and advisers may need to be renegotiated to ensure compliance with the new requirements.

- As with the current Ontario policy, the specific elements in the guidelines would not be enforceable and therefore little guarantee that all advisers would follow the guidelines or that investors would receive higher quality disclosure. As a result, regulators could continue to see many of the same issues currently found during compliance reviews.

- There would continue to be inconsistent standards across the CSA and between mutual funds and other managed investments.

Benefits

- More certainty for market participants regarding acceptable practices.

- If disclosure guidelines were adopted, investors would have more information about their adviser's use of brokerage commissions to pay for non-execution goods and services. With more information, investors will be better able monitor their adviser's behaviour and ensure conflicts of interest are kept in check.

- Increased consistency with applicable UK and US regulations will help protect the competitiveness of Canada's capital markets. However, there is no guarantee that the standards would be adopted by all industry participants.

3. Complete ban

A ban would prohibit dealers and advisers from using trading commissions to pay for anything other than trade execution. Goods and services currently paid for through soft dollar arrangements would have to be paid for directly from an adviser's management fee.

Costs

- One of the primary concerns about eliminating soft dollar commissions is the harm it may cause independent research providers. But how reliant are third-party research providers on soft dollars? The research by Greenwich Associates[14] found that over 60% of Canadian investment managers acquire third-party research via a soft dollar arrangement. As a comparison, only 27% use hard dollars to meet all or part of their independent research needs. Not only do a majority of advisers make such payments they are also of a potentially significant size. It is estimated that independent research represents 20% of all commission payments directed to third parties. As a result, prohibiting soft dollar arrangements could impact research providers. However, since no comparable jurisdiction has banned soft dollar commissions, it is difficult to assess the extent of that impact.

- Greenwich Associates also found that purchasing independent research with soft dollars is also more common for smaller investment managers[15] and so prohibiting such payments could have a larger impact on that group. Increasing costs for new advisers could create a barrier to entry and may ultimately decrease competition between advisers and reduce choice for investors.

- Soft dollar commission arrangements are permitted in other jurisdictions, most notably in the U.S. and U.K. Therefore prohibiting the practice in Canada could result in a competitive disadvantage for Canada's securities industry. The lack of harmonisation with those other jurisdictions would make it difficult for Canadian dealers to attract business from international investment managers. Also foreign investment managers may be less willing to conduct business in Canada. This could also decrease the amount of money invested in Canada and therefore the liquidity of Canada's capital markets.

- There is no definitive proof for or against the existence of economies of scope in bundling trade execution with other goods and services. However if they do exist, unbundling will result in increased costs for advisers. This could make it more expensive for new advisory firms to enter the market and would eventually reduce competition and choice for investors. The reduced competition could, over time, lead to advisers charging higher management fees.

[14] Greenwich Associates,Canadian Equities: Setting the Price for Sell Side Research, June 2005 pg 5.
[15] Greenwich 2005 Statistical Supplement, pg 12.

- There is the risk that dealers will still offer services to attract adviser business but by different means. For example, it has been suggested that banning soft dollar arrangements may result in increased principal trading by dealers. If the trade is executed by the dealer on a principal basis, the cost of that trade is built into the price and is therefore less transparent. Purchases of goods and services other than trade execution could then become less transparent for investors and regulators.

- Reflecting research costs as a management expense may motivate advisers to under-consume research and make sub-optimal decisions for their clients. Advisers may be reluctant to reduce their margins by using management fees to purchase the research. They may also be reluctant to increase those fees to pay for research, as advisers compete based upon the price they charge for their services.

- Some proprietary services offered by dealer may be difficult and/or costly to un-bundle.

Benefits

- If there are no economies of scope in the provision of bundled investment management goods and services, unbundling could result in lower costs for advisers and for investors.

- Greenwich's research indicates that 71% of Canadian investment managers would decrease their use of sell-side research if forced to pay for it with hard dollars[16.] This would indicate that advisers are over consuming dealer generated research and so prohibiting soft dollar commission arrangements would benefit investors as they would only pay for trade execution and not other services that may not generate value.

- Similarly, the current environment may be distorting the market for independent research. Advisers may also be over consuming third-party research and therefore supporting research providers and products that do not generate value for clients.

- By requiring advisers to pay for non-execution goods and services from the management fee, advisors will have an incentive to ensure that all goods and services purchased are providing value. Of the investment managers Greenwich surveyed in 2005, over a quarter purchased independent research using hard dollars.[17] Clearly advisers see more value in independent research than in its sell-side equivalent. Prohibiting soft dollar commission arrangements may then lead advisers to substitute independent for sell-side research and as a result third party providers could see sales increase.

- Client brokerage commissions would only be used to pay for trade execution. This would likely eliminate the over-consumption of non-execution-related goods and services and would diminish incentives for advisers to make investment decisions that are not in their clients' best interest.

- Management fees would reflect the true cost of hiring an adviser's expertise and the full cost of their investment approach. Investors would find it easier to compare adviser services based upon price.

4. Reformulate requirements into a National Instrument

The proposed Instrument addresses soft dollar issues by applying a uniform standard to all participating provinces and territories.

Costs

- Review of current soft dollar arrangements. The costs would be the same as those identified for Option 2, Update policy.

- Production and distribution of documentation for advisers to provide to their clients. The cost would also be the same as that identified under Option 2, Update Policy.

- The proposed instrument prohibits some services that were not clearly excluded previously. If these services did not generated sufficient value, the advisers will likely discontinue use as opposed to paying for them out of management fees. According to the Greenwich Associates research, the decreased demand is not likely to

[16] Ibid.
[17] Ibid, pg 4.

threaten the viability of the vendor's business.[18] Excluding these services from soft dollar arrangements may also encourage their vendors to offer products that do generate value for advisers.

- The increased level of disclosure will provide investors with more information about how their trading commissions are used. However, they may not have sufficient knowledge to determine if the purchased goods and services generated value and improved investment returns.

Benefits

- Although the potential for conflicts of interest will still exist, the proposed Instrument will decrease the opportunities for advisers to over-consume goods and services at the expense of their best execution obligations. The additional disclosure requirements will increase the adviser's accountability to their clients.

- Investors will be provided with sufficient information to be able to determine if the adviser is using brokerage commissions appropriately. The increased transparency will also allow investors to better compare advisers' services and so increase the competitive pressures on advisers.

- Since the instrument will have the full force of law, the threat of regulatory sanction will increase the incentives for advisers to regulate their own behaviour.

- Provides improved clarity for dealers and advisers about the goods and services that can be acquired with brokerage commissions. The Greenwich Associates research shows that advisers do use brokerage commissions to purchase services explicitly excluded in the proposed Instrument.[19] Investors will benefit from a reduction in the consumption of goods and services that do not sufficiently benefit them.

- The Canadian capital market will maintain its competitive position relative to the U.S. and U.K.

- Soft dollar arrangements can still be used to acquire independent research, helping to ensure that its providers are able to compete with dealer produced research.

- Ensures that the same standards are applied to advisers across the country. This will reduce confusion and uncertainty for investors, advisers and dealers.

- Provides incentives for advisers to be more aware of their fiduciary obligations and to provide goods and services in a cost-effective manner, or be subject to sanctions.

Conclusion

Based on our analysis, it is clear that the status quo offers little in the way of benefits and does not sufficiently protect investors. At the other extreme, prohibiting soft dollar commissions could put Canada at a competitive disadvantage and threaten the viability of Canadian independent research.

Updating the current requirements generates benefits by decreasing uncertainty for dealers and advisers and improving the clients' ability to monitor the use of their brokerage commissions. We expect dealers and advisers to incur a one-time cost of approximately $3 million when reviewing their current soft dollar practices and arrangements. The additional costs of providing more detailed disclosure to clients are not expected to be onerous, given the information that will be disclosed should already be available to advisers. Given the dollar value of brokerage commissions used for non-execution goods and services, only a small reduction would be needed to offset the cost. However, this option would not ensure consistently improved disclosure, harmonization, or enforceability and so does not meet all of our regulatory goals.

The anticipated costs of implementing the proposed Instrument are also about $3 million, but the benefits are expected to be substantial. Our analysis suggests that a national instrument that provides better guidance on the use of soft dollars and that mandates disclosure to investors is the best option. It will manage the inherent conflicts of interest without affecting the viability of independent research providers and provide stakeholders more certainty about the acceptable uses of soft dollar commissions. By introducing requirements for more meaningful, consistent and comparable disclosure, the proposed Instrument will enable investors to make more informed decisions about advisers and to better monitor their use of soft dollar arrangements.

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[18] As examples, about 27% of respondents use soft dollar credits to pay for news subscriptions and less than 10% use soft dollar credits to pay for transaction cost analysis (Greenwich Associates, Canadian Equities: Setting the Price for Sell-Side Research, June 2005, 4).

[19] Ibid.

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

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PART 1 – DEFINITIONS

1.1 Definitions – In this Instrument

“order execution services” means:

(a) order execution; and

(b) other goods or services directly related to order execution.

“research” means:

(a) advice relating to the value of securities or the advisability of effecting transactions in securities; and

(b) analyses or reports concerning securities, portfolio strategy, issuers, industries, or economic or political factors and trends.

PART 2 – APPLICATION

2.1 Application – This Instrument applies to advisers and registered dealers in circumstances where brokerage commissions are charged by a dealer in connection with the execution of a trade in securities.

PART 3 – USE OF COMMISSIONS ON BROKERAGE TRANSACTIONS

3.1 Advisers – (1) An adviser may not enter into any arrangements to use brokerage commissions, or any portion thereof, as payment for goods and services other than order execution services or research.

(2) An adviser that uses brokerage commissions as payment for order execution services or research must ensure that:

(a) the order execution services or research benefit the adviser’s client(s);

(b) the research received adds value to investment or trading decisions; and

(c) 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.

3.2 Registered Dealers – A registered dealer may not use or forward to a third party any portion of the commissions received from brokerage transactions as payment for goods and services other than order execution services or research.

PART 4 – DISCLOSURE OBLIGATIONS

4.1 Disclosure – (1) An adviser that enters into an arrangement where brokerage commissions, or any portion thereof, are used as payment for goods and services other than order execution, must provide to each of its clients on an initial basis and, thereafter, at least annually, disclosure of:

(a) the arrangements entered into relating to the use of brokerage commissions as payment for order execution services or research, including the names of the dealers and third parties that provided order execution services or research under those arrangements, and the types of goods and services provided by each of those dealers and third parties;

(b) the total brokerage commissions paid during the period reported upon, for each class of security, by all accounts or portfolios, and by the particular client's account or portfolio;

(c) for each of the brokerage commission amounts disclosed under subsection 4.1(b), a reasonable estimate of the percentages paid for:

(i) order execution only trades,

(ii) trades where order execution is bundled with other proprietary services by the dealer(s), and

(iii) trades where a portion of the commission is set aside for payment to third parties, including a breakdown of the fraction of this percentage that represents the amount for third party research, the amount for other third party services and the amount retained by the dealer(s); and

(d) a reasonable estimate of the weighted average brokerage commission per unit of security that corresponds to each of the percentages disclosed in subsections 4.1(c)(i) through (iii).

(2) An adviser must maintain details of each good or service received for which payment was made with brokerage commissions, and make this information available upon request to its clients. These details shall include:

(a) a description of the good or service received;

(b) the name of the dealer who used, or forwarded to a third party, the brokerage commissions as payment for the good or service;

(c) the name of the third-party provider, if any, of the good or service; and

(d) the date the good or service was received.

PART 5 – EXEMPTION

5.1 Exemption – (1) The regulator or the securities regulatory authority may grant an exemption from this Instrument, in whole or in part, subject to such conditions or restrictions as may be imposed in the exemption.

(2) Despite subsection (1), in Ontario, only the regulator may grant such an exemption.

(3) Except in Ontario, an exemption referred to in subsection (1) is granted under the statute referred to in Appendix B of National Instrument 14-101 *Definitions* opposite the name of the local jurisdiction.

(4) In Québec, this exemption is granted pursuant to section 263 of the *Securities Act* (R.S.Q. c. V-1.1).

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

Table of Contents

PART 1 – INTRODUCTION

1.1 Introduction – The purpose of this Companion Policy is to provide guidance regarding the various requirements of National Instrument 23-102 *Use of Client Brokerage Commissions as Payment for Order Execution Services or Research* ("Soft Dollar" Arrangements) (the "Instrument"), including:

(a) a discussion of the general regulatory purposes for the Instrument;

(b) the interpretation of various terms and provisions in the Instrument; and

(c) guidance on compliance with the Instrument.

1.2 General – Registered dealers and advisers have a fundamental obligation to act fairly, honestly, and in good faith with their clients. In addition, securities legislation in some jurisdictions requires managers of mutual funds to also exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances. The Instrument is intended to provide more specific parameters for the use of client brokerage commissions. This Companion Policy provides guidance on the characteristics of the goods and services that may be paid for with brokerage commissions, and provides some examples of certain types of permitted and non-permitted goods and services. The Instrument also sets out disclosure requirements for advisers.

PART 2 – APPLICATION OF THE INSTRUMENT

2.1 Application – In addition to registered dealers, the Instrument applies to advisers. The reference to "advisers" includes registered advisers and registered dealers that carry out advisory functions but are exempt from registration as advisers. The Instrument governs all trading of securities where payment is made with brokerage commissions, as set out in Section 2.1. The reference to "brokerage commissions" includes any commission or similar transaction-based fee. The Instrument would therefore apply to trades executed by the dealer on both a principal or agency basis, so long as brokerage commissions are charged. This may include transactions done on a net basis, if a fee can be separately broken out.

PART 3 – ORDER EXECUTION SERVICES AND RESEARCH

3.1 Definitions of Order Execution Services and Research – (1) Section 1.1 of the Instrument includes the definitions of order execution services and research and provides the broad characteristics of both.
(2) The definitions do not specify what form (e.g., electronic or paper) the order execution services or research should take, as it is the substance that is relevant in assessing whether the definitions are met.

(3) An adviser's responsibilities include determining whether any particular good or service, or portion thereof, may be paid for with brokerage commissions. In making this determination, the adviser is required under Part 3 of the Instrument to ensure both that the good or service meets the definition of order execution services or research and that it benefits the adviser's client(s).

3.2 Order Execution – (1) Section 1.1 of the Instrument defines order execution services as including order execution, as well as other goods and services directly related to order execution. For the purposes of the Instrument, the term "order execution", as opposed to "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.

(2) To be considered directly related to order execution, goods and services should generally be integral to the arranging and conclusion of the securities transactions that generated the commissions. A temporal limitation should be applied to ensure that only goods and services received by an adviser that are directly related to the execution process are considered order execution services. As a result, goods and services provided between the point at which an adviser makes an investment or trading decision and the point at which the resulting securities transaction is concluded would generally be considered order execution services. The conclusion of the resulting securities transaction occurs at the point that settlement is clearly and irrevocably completed.

(3) For example, order execution services may include trading advice, such as advice from a dealer as to how to trade an order (to the extent it relates to the execution of a specific order and is provided after the point at which the investment or trading decision is made by the adviser), custody, clearing and settlement services that are directly related to an executed order that generated commissions, algorithmic trading software and raw market data, to the extent they assist in the execution of orders.

3.3 Research – (1) The Instrument defines research as advice, analyses or reports regarding various subject matter relating to investments or trading. In Part 3 of the Instrument, there are also requirements relating to the adviser's responsibility to ensure the research adds value to investment or trading decisions. In order to add value to an investment or trading decision, research should include the expression of reasoning or knowledge and contain original thought. Information or conclusions that are commonly known or self-evident would not qualify. Permitted research may be based on both new and existing facts but should be capable of providing new insights, and not be merely a restatement or repackaging of previously stated information or conclusions. Similarly, research should involve the analysis or manipulation of information or data in arriving at meaningful conclusions. Information or data that has not been analyzed or manipulated does not reflect original thought or the expression of reasoning or knowledge. Additionally, a general characteristic of research is that, in order to link it to order execution, it should be provided before an adviser makes an investment or trading decision.

(2) For example, traditional research reports and advice as to the value of securities and the advisability of effecting transactions in securities would generally be considered research. Other examples include quantitative analytical software, market data that has been analyzed or manipulated to arrive at meaningful conclusions, and post-trade analytics from prior transactions (to the extent they help determine a subsequent investment or trading decision).

3.4 Mixed-Use Items **–** (1) Mixed-use items are those goods and services that contain some elements that may meet the definitions of order execution services or research, and other elements that either do not meet the definitions or that would not meet the requirements of Part 3 of the Instrument. Where 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. For example, a portion of the cost of post-trade analytics might be considered to be research, but advisers should use their own funds to pay for the portion that would not be considered research (for example, the portion used for compliance or internal performance monitoring).

(2) Advisers are expected to keep adequate books and records concerning the allocations made to ensure that brokerage commissions paid by clients are not used to pay for the components of mixed-use items that did not directly benefit the clients.

3.5 Non-Permitted Goods and Services – (1) Certain goods and services are not permitted as order execution services or research under the Instrument because they are not sufficiently linked to the securities transactions that generated the commissions in order to qualify. Goods and services that relate to the operation of an adviser's business rather than to the provision of services to its clients would not meet the requirements of Part 3 of the Instrument. For example, office furniture and equipment (including computer hardware), trading surveillance or compliance systems, portfolio valuation and performance measurement services, computer software that assists with administrative functions, legal and accounting services, memberships, mass-marketed or publicly-available information or publications, seminars, marketing services, and services provided by the adviser's personnel (e.g. payment of salaries, including those of research staff) would not be allowed.

PART 4 – OBLIGATIONS OF ADVISERS AND REGISTERED DEALERS

4.1 Obligations of Advisers – (1) Subsection 3.1(1) of the Instrument restricts an adviser from entering into any arrangements to use any portion of brokerage commissions for purposes other than as payment for order execution services or research, as defined in the Instrument. Arrangements consist of both formal and informal arrangements, including those informal arrangements for the receipt of such goods and services from a dealer offering proprietary, bundled services.

(2) Subsection 3.1(2) of the Instrument requires an adviser that uses brokerage commissions as payment for order execution services or research to ensure that certain criteria are met. The criteria include that the order execution services or research acquired are for the benefit of the adviser's client(s). The adviser should have adequate policies and procedures in place to allocate, on a fair and reasonable basis, the goods and services received to its client(s) whose brokerage commissions were used as payment for those goods and services.

4.2 Obligations of Registered Dealers – Section 3.2 of the Instrument does not restrict a registered dealer from forwarding to a third party, on the instructions of an adviser, any portion of the commissions it has charged on brokerage transactions to pay for order execution services or research provided to the adviser by that third party.

PART 5 – DISCLOSURE OBLIGATIONS

5.1 Timing of Disclosure – (1) Part 4 of the Instrument requires an adviser to make certain initial and periodic disclosure to its clients. Initial disclosure should be made before an adviser starts conducting business with each of its clients and then periodic disclosure should be made at least annually. The period of time chosen for the periodic disclosure should be consistent from period to period.

(2) For existing accounts, an adviser should make the initial disclosure by the earlier of six months from the date the Instrument takes effect and the date the adviser makes its first periodic disclosure. If the date of the initial disclosure for existing accounts precedes that of the first periodic disclosure, the adviser may choose to make only the disclosure required by subsection 4.1(1)(a) of the Instrument for this purpose.

5.2 Adequate Disclosure – (1) For the purposes of subsection 4.1(a) of the Instrument, disclosure of the arrangements relating to the use of brokerage commissions should include whether the adviser has entered into any such arrangements, and whether those arrangements involve goods and services provided directly or by a third party. Disclosure of the types of goods and services provided by each of the dealers and third parties named should be sufficient to provide adequate description of the goods and services received (e.g., algorithmic trading software, research reports, trading advice, etc.).

(2) For the purposes of subsection 4.1(b) of the Instrument, the brokerage commissions paid by the adviser during the period reported upon should be disclosed for each security class for which such commissions were paid, for example for equity securities, options, etc. The amount is to be disclosed both on an aggregate basis for all accounts or portfolios, and then separately for each of the accounts or portfolios managed by the adviser on behalf of the client to whom the disclosure is made.

(3) Subsection 4.1(c) of the Instrument requires disclosure of the percentages of the brokerage commissions charged, on both an aggregate and account-by-account (or portfolio-by-portfolio) basis, for trades that fall within certain categories. The purpose of this disclosure is to provide clients with clearer information about the use of the brokerage commissions spent on their behalf, and to provide more transparency about advisers' execution and allocation practices. The categories are as follows:

(a) "order execution only" trades, which, for the purposes of the Instrument, refers to the entry, handling or facilitation of an order by a dealer, which may range from "direct market access" trades to trades where the dealer is more actively involved, for example by providing capital, working the order, etc.;

(b) trades where order execution is bundled with other proprietary services by the dealer(s), such as advice as to trading strategy, research, access to issuer management, etc.;

(c) trades where a portion of the commission is set aside for payment to third parties for goods and services such as independent research, analytical software, etc, divided into three further sub-categories: the fraction allocated to third party research, to other third-party services and that retained by the dealers.

(4) For the purposes of subsection 4.1(d) of the Instrument, the weighted average brokerage commission per unit of security is the total amount of brokerage commissions paid divided by the total number of units of securities in the trades that generated those brokerage commissions. The calculations should be done separately for each of the percentages and fractions disclosed in subsections 4.1(c)(i) through (iii) of the Instrument.

(5) In order for the initial disclosure required under section 4.1 of the Instrument to be considered adequate, the adviser should provide the client with the most recent periodic disclosure, in relation to that section, that had been provided to the adviser's existing clients. The initial disclosure would not include any of the client-specific disclosure required under subsections 4.1(b) through (d) of the Instrument but should include the related aggregated brokerage commission disclosure.

(6) Subsection 4.1(2) of the Instrument requires an adviser to maintain certain details of the goods and services received for which payment was made with brokerage commissions, and to make this information available to its clients, upon request. In order to be able to meet this requirement, the adviser should maintain the information in such a manner as to facilitate requests for details covering any specified period of time. The adviser should maintain these details relating to the most recent five years.

(7) An adviser should disclose any additional information it believes would be helpful to its clients.

5.3 Form of Disclosure – Part 4 of the Instrument does not specify the form of disclosure. The form of disclosure may be determined by the adviser based on the needs of its clients, but the disclosure should be provided in conjunction with other initial and periodic disclosure relating to the management and performance of the account, portfolio, etc. For managed accounts and portfolios, the initial disclosure could be included as a supplement to the management agreement or account opening form, and the periodic disclosure could be provided as a supplement to a statement of portfolio.