

Chapter 5

Rules and Policies

5.1.1 NI 23-102 Use of Client Brokerage Commissions

NATIONAL INSTRUMENT 23-102 – USE OF CLIENT BROKERAGE COMMISSIONS

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PART 1 – DEFINITIONS

1.1 Definitions – In this Instrument,

“affiliated entity” has the meaning ascribed to it in section 1.3 of National Instrument 21-101 *Marketplace Operation*;

“client brokerage commissions” means brokerage commissions paid for out of, or charged to, a client account or investment fund managed by the adviser;

“managed account” has the meaning ascribed to it in section 1.1 of National Instrument 31-103 *Registration Requirements and Exemptions*;

“order execution goods and services” means

- (a) order execution; and
- (b) goods or services to the extent that they are directly related to order execution;

“research goods and services” means

- (a) advice relating to the value of a security or the advisability of effecting a transaction in a security,
- (b) an analysis, or report, concerning a security, portfolio strategy, issuer, industry, or an economic or political factor or trend, and
- (c) a database, or software, to the extent that it supports goods or services referred to in paragraphs (a) and (b).

- 1.2 Interpretation – Security** – For the purposes of this Instrument,
- (a) in Alberta, British Columbia, New Brunswick and Saskatchewan, “security” includes an exchange contract; and
 - (b) in Québec, “security” includes a standardized derivative.

- 1.3 Interpretation – Adviser** – For the purposes of this Instrument, “adviser” means

- (a) a registered adviser; or
- (b) a registered dealer that carries out advisory functions but is exempt from registration as an adviser.

PART 2 – APPLICATION

- 2.1 Application** – This Instrument applies to an adviser or a registered dealer in relation to a trade in a security if brokerage commissions are charged by a dealer for an account, or portfolio, over which the adviser has discretion to make investment decisions without requiring the express consent of the client, including, for greater certainty,

- (a) an investment fund; and
- (b) a managed account.

PART 3 – COMMISSIONS ON BROKERAGE TRANSACTIONS

- 3.1 Advisers** – (1) An adviser must not direct any brokerage transactions involving client brokerage commissions to a dealer in return for the provision of goods or services by the dealer or a third party, other than any of the following:

- (a) order execution goods and services;
- (b) research goods and services.

(2) An adviser that directs any brokerage transactions involving client brokerage commissions to a dealer, in return for the provision of any order execution goods and services or research goods and services by the dealer or a third party, must ensure that:

- (a) the goods or services are to be used to assist with investment or trading decisions, or with effecting securities transactions, on behalf of the client or clients; and
- (b) a good faith determination is made that the client or clients receive reasonable benefit considering both the use of the goods or services and the amount of client brokerage commissions paid.

- 3.2 Registered Dealers** – A registered dealer must not accept, or forward to a third party, client brokerage commissions, or any portion of those commissions, in return for the provision to an adviser of goods or services by the dealer or a third party, other than any of the following:

- (a) order execution goods and services;
- (b) research goods and services.

PART 4 – DISCLOSURE OBLIGATIONS

- 4.1 Disclosure** – (1) An adviser must provide the following disclosure to a client if any brokerage transactions involving the client brokerage commissions of that client have been or might be directed to a dealer in return for the provision of any good or service by the dealer or a third party, other than order execution:

- (a) before the adviser opens a client account or enters into a management contract or a similar agreement to advise an investment fund,
 - (i) a description of the process for, and factors considered in, selecting a dealer to effect securities transactions, including whether receiving goods or services in addition to order execution is a factor, and whether and how the process may differ for a dealer that is an affiliated entity;

- (ii) a description of the nature of the arrangements under which order execution goods and services or research goods and services might be provided;
 - (iii) a list of each type of good or service, other than order execution, that might be provided; and
 - (iv) a description of the method by which the determination in paragraph 3.1(2)(b) is made; and
- (b) at least annually,
- (i) the information required to be disclosed under paragraph (a) other than subparagraph (a)(iii);
 - (ii) a list of each type of good or service, other than order execution, that has been provided;
 - (iii) the name of any affiliated entity that provided any good or service referred to in subparagraph (ii), separately identifying each affiliated entity and each type of good or service provided by each affiliated entity; and
 - (iv) a statement that the name of any other dealer or third party that provided a good or service referred to in subparagraph (ii), if that name was not disclosed under subparagraph (iii), will be provided to the client upon request.

(2) An adviser must maintain a record of the name of any dealer or third party that provided a good or service, other than order execution under section 3.1, and must provide that information to the client upon request.

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 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.

PART 6 – EFFECTIVE DATE AND TRANSITION

6.1 Effective Date – This Instrument comes into force on June 30, 2010.

6.2 Transition – On or before December 31, 2010, an adviser must provide to a client, if the client was a client on June 30, 2010, the disclosure required under paragraph 4.1(1)(a) or (b).

COMPANION POLICY 23-102 CP – USE OF CLIENT BROKERAGE COMMISSIONS

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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 (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 deal fairly, honestly, and in good faith with their clients. Registered dealers and advisers are also required to make reasonable efforts to achieve best execution when acting for clients, and have certain obligations to identify and respond to conflicts of interest. Directing brokerage transactions involving client brokerage commissions to a dealer in return for the provision of goods or services other than order execution should therefore also be evaluated in light of the duty to deal fairly, honestly, and in good faith with clients, the obligation to make reasonable efforts to achieve best execution, and any requirements pertaining to conflicts of interest. The Instrument is therefore intended to provide more specific parameters for obtaining such goods or services when client brokerage commissions are involved. The Instrument also sets out disclosure requirements for advisers. This Companion Policy provides guidance on (a) the characteristics of the types of goods and services that might be eligible, including some examples; (b) the obligations of advisers and registered dealers; and (c) the disclosure obligations.

PART 2 – APPLICATION OF THE INSTRUMENT

2.1 Application – (1) The Instrument applies to advisers and registered dealers. Section 1.3 of the Instrument indicates that for the purposes of the Instrument, adviser means a registered adviser or a registered dealer that carries out advisory functions but is exempt from registration as an adviser. The Instrument governs certain trades in securities where payment for the transaction is made with client brokerage commissions, as set out in section 2.1 of the Instrument. The reference to “client brokerage commissions” includes any brokerage commission or similar transaction-based fee charged for a trade where the amount paid for the security is clearly separate and identifiable (e.g., the security is exchange-traded, or there is some other independent pricing mechanism that enables the adviser to accurately and objectively determine the amount of commissions or fees charged).

(2) The limitation of the Instrument to trades for which a brokerage commission is charged is based on the practical difficulties in applying these requirements to transactions such as principal transactions where an embedded mark-up is charged. An adviser that obtains goods or services other than order execution in conjunction with such transactions is subject to its duty to deal fairly, honestly, and in good faith with clients, and its obligation to make reasonable efforts to achieve best execution when acting for clients. As a result, an adviser should consider the goods or services obtained in relation to its duty to deal fairly, honestly, and in good faith with its clients, and in its evaluation of best execution. In addition, an adviser should also consider any relevant conflict of interest provisions, given the incentives created for advisers to place their interests ahead of their clients when obtaining goods or services other than order execution in conjunction with such transactions.

PART 3 – ORDER EXECUTION GOODS AND SERVICES AND RESEARCH GOODS AND SERVICES

3.1 Definitions of Order Execution Goods and Services and Research Goods and Services – (1) Section 1.1 of the Instrument includes the definitions of order execution goods and services and research goods and services and provides the broad characteristics of both.

(2) The definitions do not specify what form (e.g., electronic or paper) the goods or services should take, as it is their 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 of a good or service, may be obtained through brokerage transactions involving client 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 goods and services or research goods and services and that it is to be used to assist with investment or trading decisions or with effecting securities transactions on behalf of the client or clients.

3.2 Order Execution Goods and Services – (1) Section 1.1 of the Instrument defines "order execution goods and services" as including the actual execution of the order itself, as well as goods or services to the extent that they are directly related to order execution. For the purposes of the Instrument, the term "order execution", as opposed to "order execution goods and services", refers to the entry, handling or facilitation of an order whether by a dealer or by an adviser (for example, through direct market access or as a subscriber to an alternative trading system), but not other goods or services provided to aid in the execution of trades.

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

(3) For example, order execution goods and services may include order management systems (to the extent they help arrange or effect a securities transaction), algorithmic trading software and market data (to the extent they assist in the execution of orders), and custody, clearing and settlement services that are directly related to an executed order that generated commissions.

3.3 Research Goods and Services – (1) The Instrument defines research goods and services as including advice, analyses or reports regarding various subject matter relating to investments, as well as databases and software to the extent that they support these goods or services. In order to be eligible, research goods and services generally should reflect the expression of reasoning or knowledge and be related to the subject matter referred to in the definition (i.e., securities, portfolio strategy, etc.). We would also consider databases and software that are used by advisers in support of or as an alternative to the provision by dealers of advice, analyses and reports to be research goods and services to the extent they relate to the subject matter referred to in the definition. Additionally, a general characteristic of research goods and services is that, in order to link these to order execution, they should be provided or used before an adviser makes an investment or trading decision.

(2) For example, traditional research reports, publications marketed to a narrow audience and directed to readers with specialized interests, seminars and conferences (i.e., fees, but not incidental expenses such as travel, accommodations and entertainment costs), and trading advice, such as advice from a dealer as to how, when or where to trade an order (to the extent it is provided before an order is transmitted), would generally be considered research goods and services. Databases and software that could be eligible as research goods and services could include quantitative analytical software, market data from feeds or databases, post-trade analytics from prior transactions (to the extent they are used to aid in a subsequent investment or trading decision), and possibly order management systems (to the extent they provide research or assist with the research process).

3.4 Mixed-Use Items – (1) Mixed-use items are those goods or services that contain some elements that may meet the definitions of order execution goods and services or research goods and services, 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 obtained by an adviser through brokerage transactions involving client brokerage commissions, the adviser should make a reasonable allocation of those commissions paid according to the use of the goods or services. For example, client brokerage commissions might be involved when paying for the portion of order management systems used in the order execution process, but an adviser should use its own funds to pay for any portion of the systems used for compliance, accounting or recordkeeping purposes.

(2) For purposes of making a reasonable allocation, an adviser should make a good faith estimate supported by a fact-based analysis of how the good or service is used, which may include inferring relative costs from relative benefits. Factors to consider might include the relative utility derived from, or the time for which the good or service is used, eligible and ineligible uses.

(3) Advisers are expected to keep adequate books and records concerning the allocations made.

3.5 Non-Permitted Goods and Services – We consider certain goods and services to be clearly outside the scope of the permitted goods and services under the Instrument because they are not sufficiently linked to the securities transactions that generated the commissions. Goods and services that relate to overhead associated with 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. Examples of non-permitted goods and services include office furniture and equipment (including computer hardware), trading surveillance or compliance systems, costs associated with correcting error trades, portfolio valuation and performance measurement services, computer software that assists with administrative functions, legal and accounting services relating to the management of an adviser's own business or operations, memberships, marketing services, and services provided by the adviser's personnel (e.g. payment of salaries, including those of research staff).

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 directing any brokerage transactions involving client brokerage commissions to a dealer in return for the provision of goods or services by the dealer or a third party, other than order execution goods and services or research goods and services, as defined in the Instrument. This applies when brokerage transactions involving client brokerage commissions are used to obtain order execution goods and services or research goods and services under both formal and informal arrangements, including informal arrangements for the receipt of these goods and services from a dealer offering proprietary, bundled services. This would also apply when brokerage transactions involving client brokerage commissions are directed to any dealer, including where the adviser has direct market access or is a subscriber to an alternative trading system.

(2) Subsection 3.1(2) of the Instrument requires an adviser that directs any brokerage transaction involving client brokerage commissions to a dealer, in return for the provision of order execution goods and services or research goods and services by the dealer or a third party, to ensure that certain criteria are met. The criteria included under paragraph 3.1(2)(a) requires the adviser to ensure that the goods or services acquired are to be used to assist with investment or trading decisions, or with effecting securities transactions, on behalf of the adviser's client or clients. The goods or services should therefore be used in a manner that provides appropriate assistance to the adviser in making these decisions, or in effecting such transactions. A good or service that meets the definition of order execution goods and services or research goods and services, but is not to be used to assist the adviser with investment or trading decisions, or with effecting securities transactions, should not be obtained through brokerage transactions involving client brokerage commissions. The adviser should be able to demonstrate how the goods or services obtained under the Instrument are used to provide appropriate assistance.

(3) Paragraph 3.1(2)(b) of the Instrument requires the adviser to ensure that a good faith determination is made that the client or clients receive reasonable benefit considering both the use of the goods or services and the amount of client brokerage commissions paid. Benefit to the client is generally derived from the use of the goods and services (i.e., the assistance provided in relation to investment or trading decisions made, or securities transactions effected, on behalf of the client or clients), and is generally relative to the amount of client brokerage commissions paid. The determination required under paragraph 3.1(2)(b) can be made either with respect to a particular transaction or the adviser's overall responsibilities for client accounts.

(4) Also for the purposes of subsection 3.1(2) of the Instrument, a specific order execution good or service or research good or service may be used to benefit more than one client, and may not always be used to directly benefit each particular client whose brokerage commissions paid for the brokerage transactions through which the particular good or service was obtained. However, the adviser should have adequate policies and procedures in place, and apply those

policies and procedures, so that, over time, all clients whose brokerage commissions may have been involved with such transactions receive fair and reasonable benefit.

(5) An adviser that, by virtue of paying client brokerage commissions on brokerage transactions, is provided with access to or receives goods or services on an unsolicited basis should consider whether or how usage of those goods or services has affected its obligations under the Instrument as part of its process for assessing compliance with the Instrument. For example, if an adviser considers unsolicited goods or services as a factor when selecting dealers or allocating brokerage transactions to dealers, the adviser should include these goods or services when assessing compliance with the obligations of the Instrument, and should include these in its disclosure.

- 4.2 Obligations of Registered Dealers** – Section 3.2 of the Instrument indicates that a registered dealer must not accept, or forward to a third party, client brokerage commissions, or any portion of those commissions, in return for the provision to an adviser of goods or services by the dealer or a third party, other than order execution goods and services and research goods and services. A dealer may forward to a third party, on the instructions of an adviser, any portion of those commissions in return for order execution goods and services or research goods and services provided to the adviser by that third party. In either situation, the dealer would need to make an assessment as to whether or not the goods or services being paid for meet the definitions of order execution goods and services or research goods and services, in order to be meeting its obligations.

PART 5 – DISCLOSURE OBLIGATIONS

- 5.1 Disclosure Recipient** – Part 4 of the Instrument requires an adviser to provide certain disclosure to a client if any brokerage transactions involving the client brokerage commissions of that client have been or might be directed to a dealer in return for the provision of any goods or services by the dealer or a third party, other than order execution. The recipient of the disclosure should typically be the party with whom the contractual arrangement to provide advisory services exists. For example, for an adviser to an investment fund, the client would typically be considered the fund for purposes of the disclosure requirements.

- 5.2 Timing of Disclosure** – 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 opens a client account or enters into a management contract or a similar agreement to advise an investment fund 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.

- 5.3 Adequate Disclosure** – (1) For the purposes of the disclosure made under section 4.1 of the Instrument, the information disclosed by an adviser may be client-specific, based on firm-wide information, or based on some other level of customization, so long as the information disclosed relates to those clients to whom the disclosure is directed. In any case, the disclosure required to be made by the adviser under section 4.1 of the Instrument would also reflect information pertaining to the processes, practices, arrangements, types of goods and services, etc., associated with brokerage transactions involving client brokerage commissions that have been or might be directed to dealers by its sub-advisers in return for the provision of any goods and services other than order execution.

(2) Also for the purposes of the disclosure under section 4.1 of the Instrument the use of the phrase “might be” in the requirement to make disclosure in situations where brokerage transactions involving client brokerage commissions have been or might be directed relates primarily to the disclosure to be made on an initial basis under paragraph 4.1(1)(a) of the Instrument. It is intended to require that the initial disclosure be made if it is or becomes reasonably foreseeable that brokerage transactions involving a new client’s brokerage commissions could be directed in such a manner – for example, if brokerage transactions involving other existing clients’ brokerage commissions are directed in such a manner, and it is likely that trades to be made on behalf of the new client will be aggregated with those made on behalf of the other existing clients.

(3) For the purposes of subparagraph 4.1(1)(a)(ii) of the Instrument, disclosure of the nature of the arrangements under which order execution goods and services or research goods and services might be provided should include whether goods and services are provided directly by a dealer or by a third party, and a description of the general mechanics of how client brokerage commissions are charged and might translate into payment for order execution goods and services and research goods and services.

(4) For the purposes of subparagraphs 4.1(1)(a)(iii) and 4.1(1)(b)(ii) of the Instrument, disclosure of each type of good or service should be sufficient to provide adequate description of the goods or services received (e.g., algorithmic trading software, research reports, trading advice, etc.).

(5) For purposes of subparagraph 4.1(1)(a)(iv), to the extent that more than one method is used, the description should be of those methods.

- 5.4 Form of Disclosure** – Part 4 of the Instrument does not specify the form of disclosure. The adviser may determine the form of disclosure 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 or portfolio. For managed accounts and portfolios, the initial disclosure could be included as a supplement to the management contract or similar agreement or the account opening form, and the periodic disclosure could be provided as a supplement to a statement of portfolio.