

# Chapter 5

## Rules and Policies

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### 5.1.1 NI 23-102 Use of Client Brokerage Commissions and Companion Policy 23-102CP

#### CANADIAN SECURITIES ADMINISTRATORS

#### NOTICE OF

#### NATIONAL INSTRUMENT 23-102 USE OF CLIENT BROKERAGE COMMISSIONS

#### AND

#### COMPANION POLICY 23-102CP

### I. INTRODUCTION

The Canadian Securities Administrators (the CSA or we) have made National Instrument 23-102 – *Use of Client Brokerage Commissions* (Instrument) and Companion Policy 23-102CP (Companion Policy). The Instrument and Companion Policy set out requirements pertaining to brokerage transactions involving client brokerage commissions that are directed to a dealer in return for the provision of order execution goods and services or research goods and services.

The final text of the Instrument and Companion Policy is being published concurrently with this Notice and can also be obtained on the websites of various CSA members.

Subject to Ministerial approval requirements, the Instrument will come into force on June 30, 2010 in all CSA jurisdictions. The Companion Policy will come into force at the same time. Additional information regarding the implementation or adoption of the Instrument in each province or territory is included in Appendix A to this Notice.

Ontario Securities Commission Policy 1.9 – *Use by dealers of brokerage commissions as payment for goods or services other than order execution services (“Soft Dollar” Deals)*, and Autorité des marchés financiers Policy Statement Q-20 of the same name (together, the Existing Provisions), will be rescinded, effective on the date that the Instrument and Companion Policy come into force in Ontario and Québec, respectively.

### II. BACKGROUND

#### A. First publication for comment

On July 21, 2006, the CSA published for comment a notice, a proposed National Instrument (2006 Instrument) and a proposed Companion Policy (together, the 2006 Proposal)<sup>1</sup>, relating to the subject matter of the final Instrument.

Forty-three comment letters were received by the CSA in response to the 2006 Proposal. A summary of the comments and our responses were published at (2008) 31 OSCB 499.

#### B. Second publication for comment

After consideration of the comments received, material changes were made to the 2006 Proposal. The CSA published a revised proposal for comment on January 11, 2008 (2008 Proposal)<sup>2</sup>, which included the following:

- Notice of Proposed National Instrument 23-102 and Companion Policy 23-102CP (2008 Notice);
- Proposed National Instrument 23-102 – *Use of Client Brokerage Commissions as Payment for Order Execution Services or Research Services* (2008 Instrument); and
- Proposed Companion Policy 23-102CP (2008 Policy).

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<sup>1</sup> Published at (2006) 29 OSCB 5923.

<sup>2</sup> Published at (2008) 31 OSCB 489.

The CSA invited public comment on all aspects of the 2008 Proposal and specifically requested comments on four questions. A total of 21 comment letters were received. We have considered the comments received and thank all of the commenters for their submissions. A list of those who submitted comments, as well as a summary of comments and our responses to them, are attached as Appendix B to this Notice.

### III. SUBSTANCE AND PURPOSE OF INSTRUMENT AND COMPANION POLICY

After consideration of the comments to the 2008 Proposal, some changes have been made to the Instrument and Companion Policy since the 2008 Proposal. However, the purpose of the Instrument and Companion Policy remain the same.

The Instrument provides a specific framework for obtaining goods and services other than order execution in connection with client brokerage commissions. It clarifies the broad characteristics of the goods and services that may be acquired by advisers in these circumstances, and also describes the advisers' disclosure obligations. The Instrument also sets out the obligations of registered dealers.

The Companion Policy gives guidance regarding the types of goods and services that may be obtained, 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 Instrument.

### IV. SUMMARY OF CHANGES TO 2008 PROPOSAL

The changes made to the Instrument and Companion Policy since the 2008 Proposal are intended to clarify and simplify the requirements of the Instrument, and respond to comments received.

A summary of the key revisions made to the Instrument and the Companion Policy since the 2008 Proposal are set out below. More information on certain of these changes, and on other changes not included in the discussion below, is available in the summary of comments and responses included at Appendix B.

#### A. Definitions of Order Execution Goods and Services and Research Goods and Services

##### (i) *Temporal standard for order execution goods and services*

The temporal standard for order execution goods and services generally defines the points where eligibility for these goods and services begins and ends. In the 2008 Proposal, we proposed that the temporal standard should start after the point at which an investment decision has been made. Some commenters expressed support for the proposed temporal standard, but others expressed concern with the difference between the standard proposed and that included in the SEC's 2006 interpretive release (SEC Release)<sup>3</sup>.

As a result, we have decided to return to the temporal standard for order execution goods and services proposed in the 2006 Instrument to more closely align its starting point with that included in the SEC Release, and to avoid any potential for confusion. More specifically, subsection 3.2(2) of the Companion Policy now refers to the starting point for the temporal standard as being the point after which an investment or trading decision has been made. In addition, we have also amended paragraph (a) of the definition of 'research goods and services' under Part 1 of the Instrument to revert back to similar language from the 2006 Instrument. The definition now indicates that research goods and services includes "advice relating to the value of a security or the advisability of effecting a transaction in a security".

In our view, these changes will only affect the classification of a good or service previously considered eligible as order execution goods and services under the 2008 Proposal. For example, trading advice provided to an adviser before an order is transmitted (which may be advice relating to the advisability of effecting a transaction in a security) and post-trade analytics from prior transactions (to the extent they are used in the subsequent determination of how, when or where to place an order) might now be eligible as research goods and services.

#### B. Application of the Instrument

##### (i) *Application to trades in futures*

Some commenters requested clarification regarding the application of the Instrument to trades in futures contracts. We note that the 2008 Instrument proposed to apply to "any trade in securities ... where brokerage commissions are charged by a

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<sup>3</sup> The SEC Release was issued on July 18, 2006 under Exchange Act Release No. 34-54165. Under the temporal standard included in the SEC Release, "brokerage begins when the money manager communicates with the broker-dealer for the purpose of transmitting an order for execution and ends when funds or securities are delivered or credited to the advised account or account holder's agent" (SEC Release, pp. 40-41).

dealer.” Consequently, it was intended to apply to trades in a futures contract to the extent that the futures contract would meet the definition of a security, and brokerage commissions were charged.

However, in certain jurisdictions, the definition of “security” does not include futures contracts. Part 1 of the Instrument has been changed to clarify this intention, and to reflect the CSA’s view that the same conflicts and issues arise, regardless of the type of security involved.

*(ii) Application to principal transactions where an embedded mark-up is charged*

Comments received suggested that the guidance included in subsection 2.1(2) of the 2008 Policy which would have left principal transactions where an embedded mark-up is charged, outside of the scope of the Instrument, would lead to an inconsistent level of disclosure compared to trades that are subject to the Instrument.

We have amended the guidance in subsection 2.1(2) of the Companion Policy to add that an adviser that obtains goods and 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. We continue to believe that it may be more difficult for an adviser to demonstrate that it has met its duty to deal fairly, honestly, and in good faith with its clients, and its obligation to make reasonable efforts to achieve best execution, if it does not have sufficient information regarding the amount of mark-up that might have been charged in aggregate for the execution and additional goods and services obtained.

In addition, an adviser that obtains goods and services other than order execution in conjunction with such a trade outside of the Instrument should also consider any relevant conflict of interest provisions, given the incentives created for advisers to place their interests ahead of their clients. For example, we note that in connection with the conflict of interest provisions included in section 13.4 of National Instrument 31-103 *Registration Requirements and Exemptions* (NI 31-103), an adviser would have to consider issues such as how to control the existing or potential conflicts of interest associated with the use of client assets in such a manner, and whether and what disclosure it might need to provide to clients regarding the nature and extent of the conflicts of interest.

We will continue to monitor the use of such principal trades to obtain goods and services other than order execution, and will consider whether the Instrument should be amended in the future to bring such trading within the scope of the Instrument.

*(iii) Application to unsolicited goods or services*

Some commenters sought clarification about the intention of the guidance included in subsection 4.1(4) of the 2008 Policy pertaining to unsolicited goods or services.

To provide additional clarification, we have amended the guidance in the Companion Policy (now subsection 4.1(5)) to clarify that an adviser that 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. Additional details can be found in subsection 4.1(5) of the Companion Policy.

**C. Obligations under the Instrument**

*(i) Obligations of advisers*

Drafting changes have been made in relation to the obligations of advisers under section 3.1 of the Instrument, and were intended to better clarify these obligations.

First, subsection 3.1(1) of the 2008 Instrument has been revised to state that “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,…”<sup>4</sup> This change is intended to reflect that the client brokerage commissions are ultimately associated with the brokerage transactions directed by the adviser on behalf of its client or clients. In addition, language has been added to ensure that it is clear that goods and services other than order execution obtained by the adviser, under the Instrument, can be provided by either the dealer or a third party. We also note that the resulting language is consistent with the long-standing language of the Existing Provisions.

Second, paragraph 3.1(2)(a) of the 2008 Instrument, which would have required an adviser to ensure that the order execution goods and services and research goods and services obtained benefit the client or clients, has been revised. The 2008 Policy

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<sup>4</sup> As a result of this drafting change, similar drafting changes were also required elsewhere in the Instrument and Companion Policy to ensure consistency of the language used throughout, including drafting changes to Part 4 of the Instrument regarding disclosure requirements.

explained that, in order to benefit a client, the goods or services obtained should be used to assist with investment or trading decisions, or with effecting securities transactions. This expectation is now more clearly reflected in paragraph 3.1(2)(a) of the Instrument which explicitly requires the adviser to ensure that 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.

Finally, the concept of reasonable benefit to an adviser's client or clients that had been discussed in subsection 4.1(3) of the 2008 Policy has now been combined with the requirement to ensure that a good faith determination is made that the amount of client brokerage commissions paid is reasonable in relation to the value of the order execution goods and services or research goods and services received (from paragraph 3.1(2)(b) of the 2008 Instrument). We note that benefit (and value) to the client is generally derived from the use of the goods and services (that is, 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. Subsection 3.1(2)(b) of the Instrument now indicates that the adviser must 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." Further clarification regarding this obligation is included in subsection 4.1(3) of the Companion Policy.

*(ii) Obligations of dealers*

Some commenters to the 2008 Instrument requested clarification regarding the expected level of due diligence to be performed by dealers in meeting their obligations under the Instrument when assessing the eligibility of goods and services being provided to the adviser in return for client brokerage commissions.

To provide more guidance, we have amended Section 4.2 of the Companion Policy to reflect our expectation that a dealer would have to make an assessment that the goods or services being paid for, or those that the dealer has been asked to pay for, meet the definitions of order execution goods and services or research goods and services.

We think that a dealer should be able to identify when a good or service clearly does not meet the definition of order execution goods and services or research goods and services, including when it has been asked by an adviser to pay a third-party invoice. When it is not clear as to whether the good or service meets one of the definitions, or when the description on the invoice is insufficient to determine the nature of the good or service, an inquiry should be made with the adviser before accepting payment or agreeing to pay.

**D. Disclosure**

*(i) General*

In response to comments, we have made amendments to the disclosure requirements contained in Part 4 of the Instrument to separate the requirements for initial and periodic disclosure.

We have not, as suggested from certain comments, made changes to Part 4 of the Instrument to require explicit statements pertaining to the conflicts of interest that are inherent when obtaining goods and services other than order execution in connection with client brokerage commissions.

However, we note that subsection 13.4(3) of NI 31-103 requires disclosure, in a timely manner, of the nature and extent of the conflict of interest to the client whose interest conflicts with the interest identified, if a reasonable investor would expect to be informed of a conflict of interest identified under subsection 13.4(1) of NI 31-103. The guidance provided in section 13.4 of the Companion Policy 31-103CP indicates that, among other things, the disclosure should explain the conflict of interest and how it could affect the service the client is being offered.

In our view, under subsection 13.4(3) of NI 31-103, an adviser should also explicitly identify and explain the conflicts of interest inherent when obtaining goods and services other than order execution in connection with client brokerage commissions, and how those conflicts could affect the service the client is being offered.

*(ii) Narrative disclosure*

We agree with the suggestion that, for some clients, disclosure of a list of dealers and third-party suppliers may not be useful information. Accordingly, we have revised Part 4 of the Instrument to evidence an 'upon request' approach for disclosure of the names of dealer and third-party suppliers, except in relation to affiliated entities.

We maintain our view that clients would find disclosure of the types of goods and services acquired in connection with brokerage transactions involving client brokerage commissions to be useful information. We also maintain that, for goods and services provided by affiliated entities, the inherent conflicts of interest in dealings with such entities necessitates that the names of these entities and the types of goods and services they provided should be separately identified.

(iii) *Quantitative disclosure*

Numerous comments were received in relation to the quantitative disclosure proposed in the 2008 Instrument. The commenters' primary concerns can be summarized as follows:

- Persisting valuation issues associated with bundled goods and services will likely result in differences in the methodologies used by advisers for purposes of estimating value for disclosure. This will likely affect both the comparability and usefulness of the disclosure to clients.
- To go further than the requirements of the SEC or other international regulators at this time would create difficulties for Canadian advisers conducting business in multiple jurisdictions, particularly for those that contract a foreign sub-adviser subject to lesser disclosure requirements in their home jurisdiction (who may or may not be willing to undertake systems changes to provide the needed information). This could have an impact on costs to Canadian investors, or result in differences in the quality of disclosure.

As a result of the comments received and developments in the U.S. referred to in Appendix B, we have decided not to proceed with quantitative disclosure requirements at this time. However, we will monitor industry and regulatory developments here and in other jurisdictions to determine if it might be appropriate to propose quantitative disclosure requirements in the future. In the interim, we believe that the narrative disclosure requirements will provide useful information to clients and increase accountability on the part of advisers.

We also note that the quantitative disclosure requirements applicable to investment funds under National Instrument 81-106 have been maintained. The reasons for maintaining these requirements include: (i) disclosure under NI 81-106 not only informs, to the extent ascertainable, the amount of commission paid for goods and services other than order execution, but also provides information relevant to other amounts disclosed under NI 81-106, such as the trading expense ratio (which expresses total commissions and other portfolio transaction costs as an annualized percentage of daily average net assets over the period); and (ii) NI 81-106 applies to a narrower scope of advisers (i.e., advisers to an investment fund).

**E. Transition Period**

As we are not proceeding with quantitative disclosure requirements at this time, we believe that the six month transition period proposed in the 2008 Proposal is sufficient.

**V. RELATED INSTRUMENTS**

The Instrument and Companion Policy are related to, and are intended to replace, the Existing Provisions. The Existing Provisions will be rescinded, effective on the same date that the Instrument and Companion Policy come into force in Ontario and Québec, respectively.

**VI. ALTERNATIVES AND ANTICIPATED COSTS AND BENEFITS**

Alternatives that were considered, and the potential costs and benefits were discussed in the cost-benefit analysis included in Appendix B of the 2008 Proposal.

We continue to believe that a National Instrument that governs the practice of directing brokerage transactions involving client brokerage commissions in return for goods and services other than order execution, and that mandates disclosure to investors is the best option. Further, we believe that the net effect of the changes made to the Instrument and Companion Policy since the 2008 Proposal will reduce the potential costs to dealers and advisers associated with the implementation of the Instrument.

**VII. QUESTIONS**

Please refer any of your questions to any of:

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**Rules and Policies**

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October 6, 2009

**APPENDIX A**

**IMPLEMENTATION OR ADOPTION OF THE INSTRUMENT**

The Instrument will be implemented as:

- a rule in each of Alberta, British Columbia, Manitoba, Newfoundland and Labrador, Nova Scotia, New Brunswick, Ontario and Prince Edward Island;
- a regulation in each of Québec, the Northwest Territories, Nunavut and the Yukon Territory; and
- a commission regulation in Saskatchewan.

The Companion Policy will be adopted as a policy in each of the jurisdictions represented by the CSA.

In Ontario, the Instrument and other required materials were delivered to the Minister of Finance on September 30, 2009. The Minister may approve or reject the Instrument or return it for further consideration. If the Minister approves the Instrument (or does not take any further action), the Instrument will come into force on June 30, 2010.

In Québec, the Instrument is a regulation made under section 331.1 of The Securities Act (Québec) and must be approved, with or without amendment, by the Minister of Finance. The Instrument will come into force on the date of its publication in the Gazette officielle du Québec or on any later date specified in the regulation. It is also published in the Bulletin of the Autorité des marchés financiers.

In British Columbia, the implementation of the Instrument is subject to ministerial approval. Provided all necessary approvals are obtained, British Columbia expects the Instrument to come into force on June 30, 2010.

APPENDIX B

SUMMARY OF COMMENTS AND RESPONSES ON THE 2008 PROPOSAL

I. DEFINITIONS OF ORDER EXECUTION GOODS AND SERVICES AND RESEARCH GOODS AND SERVICES

A. *Temporal standard – Comments on Question 1 from the 2008 Notice*

*Question – What difficulties might be caused by a temporal standard for order execution goods and services that might differ from the standard applied by the SEC, especially in the absence of any detailed disclosure requirements in the U.S.? In the event difficulties might result, do these outweigh any benefit from having a temporal standard that results in consistent classification of goods and services based on use?*

Seven commenters were in favour of adopting the proposed temporal standard. Reasons provided included that it:

- better defines where best execution measurements should be applied, as any party controlling a trade from the time an investment decision has been made can enhance or detract from best execution; and
- is broader and more flexible than that of the SEC, allowing many services that have become essential to the investment process and best execution.

Of the commenters that suggested adoption of the proposed temporal standard, three did not see any material problems arising as a result of the difference with the SEC standard or any impact on the eligibility of goods and services, indicating the impact would only be a difference in the actual classification of the eligible goods and services.

Four commenters either expressed indifference between the proposed temporal standard and the SEC temporal standard, or did not explicitly take a position. These commenters generally commented that while they did not see any effect of the difference in the two standards in relation to the eligibility of goods and services, they did believe the difference would have an impact on the systems, tracking, compliance and reporting for advisers operating in both Canada and the U.S. as a result of the difference in quantitative disclosure requirements in these two jurisdictions. One of these commenters also suggested that the proposed temporal standard created a less precise definition of when goods and services are eligible, and that the longer duration relative to the SEC temporal standard may allow for a greater number of order execution goods and services to be eligible.

Four commenters were not in favour of adopting the proposed temporal standard for the following reasons:

- although the proposed temporal standard is better aligned with the trade order life cycle and broader than the SEC temporal standard, the difference would be of little practical benefit to Canadian advisers that transact in the U.S., and an unlevel playing field may result between those advisers using Canadian brokers relative to those that use both Canadian and U.S. brokers;
- using a temporal standard that is different from that used in the U.S. may increase reporting difficulties, add to the cost of disclosure, pose more challenges in the future as new products evolve, and increase client confusion.

Of these four commenters, three recommended adopting the SEC temporal standard. The other recommended adopting the starting point of the FSA's temporal standard of "... the point when the investment manager makes an investment or trading decision..." and the SEC's end-point of "when the funds or securities are delivered or credited to the advised account of the account holder's agent". Despite this recommendation, this commenter did view the proposed temporal standard as being similar enough to the SEC's temporal standard that the differences should not cause substantial difficulties for advisers, and noted that the result might be that some of the services that might be categorized as order execution services proposed in the 2008 Instrument could be defined as research permitted under Section 28(e) of the Exchange Act.

**Response:**

*In our view, and consistent with the view of certain commenters, the difference between the starting point of the SEC's temporal standard and the standard proposed in the 2008 Instrument would not have affected the eligibility of goods and services, and would only have affected the classification of an eligible good or service.*

*However, in order to avoid potential confusion, as highlighted by some of the comments, we have reverted back to the starting point of the temporal standard proposed in the 2006 Instrument – after an investment or trading decision has been made. We believe that once an adviser has made an investment or trading decision, the next step would generally involve the transmission of an order to the dealer. As a result, we believe we have reasonably harmonized the starting point of the temporal standard with that of the SEC standard.*

*This change would effectively broaden the scope of eligible ‘research goods and services’, and narrow the scope of eligible ‘order execution goods and services’. To reflect this change, we have also amended paragraph (a) of the definition of ‘research goods and services’ under the Instrument to revert back to similar language from the 2006 Instrument. The definition now indicates that these services include “advice relating to the value of a security or the advisability of effecting a transaction in a security”.*

*This will affect the previous classification of certain goods and services previously considered eligible as order execution goods and services. For example, trading advice provided to an adviser before an order is transmitted (which would likely constitute ‘advice relating to the advisability of effecting a transaction in a security’), and post-trade analytics from prior transactions (to the extent they are used to aid in a subsequent decision of how, when or where to place an order), might now be eligible as ‘research goods and services’.*

**B. Eligibility of certain goods and services**

(i) Raw market data

One commenter suggested that the example of possible eligible research goods and services provided in subsection 3.3(2) of the 2008 Policy of “market data from feeds or databases that has been or will be analyzed or manipulated to arrive at meaningful conclusions” may only contribute to confusion as to what kind of analysis or manipulation an adviser needs to undertake, and may add burden for advisers operating in both the U.S. and Canada given the SEC’s guidance that would allow raw market data that provides appropriate assistance in the investment-decision making process.

**Response:**

*We agree that the additional language regarding the use of market data is likely not necessary given the obligation in subsection 3.1(2) of the Instrument for an adviser to ensure that the goods and 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 the related guidance provided in subsection 4.1(2) of the Companion Policy. In our view, in order for raw market data to provide any assistance in the investment or trading decision-making processes, an adviser would have to at least analyze the data in some manner. We have therefore made amendments to subsection 3.3(2) of the Companion Policy to remove the additional language.*

(ii) Error or correcting trades

One commenter indicated it is their belief that the costs for correcting error trades are ineligible for commission payment in Canada, and recommended that any controversial commission use addressed in the SEC Release should also be addressed in any final instrument.

**Response:**

*Examples of goods and services that might be eligible, or that are not permissible, are intended solely to help an adviser with its assessment of whether a good or service might meet the definition of order execution goods and services or research goods and services.*

*However, in relation to error or correcting trades and their associated costs, we believe that an amendment to section 3.5 of the Companion Policy regarding non-permitted goods and services is required to provide clarification that such costs should not be obtained through brokerage transactions involving client brokerage commissions. In our view, if such costs were paid for in such a manner, the adviser would benefit as it would avoid the cost of correcting its own error, and should instead pay for these costs itself as overhead (i.e., a cost of doing business).*

(iii) *Direct telephone and dedicated connectivity lines*

Three commenters suggested that direct telephone and dedicated connectivity lines used for communication of orders to dealers should be eligible goods and services as they:

- assist with order entry as an important first step towards executing the trade;
- are generally located on the trading desks for use to place an order;
- fall within the temporal standard proposed in the 2008 Instrument;
- are often dedicated for order execution purposes only, distinguishing them from other overhead expenses that might be used in the course of a trade but generally not dedicated for such uses;
- have historically been viewed as an integral part of an execution management system;
- are more frequently required as a result of an increase in bandwidth requirements associated with the vast amount of data being aggregated and delivered to the buy-side desk and the introduction of multiple markets; and
- are eligible in the U.S., resulting in an unlevel playing field for Canadian advisers relative to U.S. advisers.

Of these commenters, one suggested that direct telephone and dedicated connectivity lines should be eligible as order execution goods and services so long as they are used solely for the purpose of order execution, another suggested they be considered mixed-use if used for purposes other than order execution, and the other added that while the dedicated connections should be eligible, the networks, computers and other hardware used by the adviser should be viewed as infrastructure and therefore considered ineligible.

**Response:**

*Based on the comments received, and in the interests of harmonizing with the SEC, we agree that dedicated connectivity lines, and other similar dedicated connectivity services, directly related to the execution, clearing and settlement of securities transactions might be eligible as order execution goods and services. This would not include phone systems, computer hardware, or other similar overhead type expenses.*

(iv) *Inclusion of pre-trade analytics as an example of potentially eligible order execution services*

Two commenters noted that the response to questions about the eligibility of pre-trade analytics in the 2008 Comment Summary indicated that these might be eligible as order execution goods and services to the extent used to help determine how, where and when to place an order or effect a trade. These commenters suggested including pre-trade analytics as an example of potentially eligible order execution services in any final Companion Policy, for clarity and future certainty.

**Response:**

*We reiterate the statement made in the 2008 Notice that it is not feasible to attempt to include in the Companion Policy a comprehensive list of all goods and services that might be considered eligible as order execution goods and services or research goods and services. The examples proposed are intended solely to help an adviser with its assessment of whether a good or service might meet the definition of order execution goods and services or research goods and services. On that basis, we continue to believe it is not necessary to explicitly refer to pre-trade analytics in the Company Policy.*

*Note, however, that the change in the temporal standard referred to earlier now means that pre-trade analytics (to the extent used to help determine how, where and when to place an order or effect a trade) could no longer be eligible as order execution goods and services, but might instead be eligible as research goods and services.*

(v) *Alternative order execution products and services*

One commenter, in reference to the guidance provided in section 3.2(1) of the 2008 Policy that states that “the term ‘order execution’ means the entry, handling or facilitation of an order whether by a dealer or by an adviser through direct market access...” suggested that the guidance should be amended to include reference to alternative trading systems, electronic communication networks, algorithmic trading systems, etc., in order to recognize that these alternative means of order input can also be part of the order execution process.

**Response:**

*The intention was to define 'order execution' for purposes of the Instrument along the lines of the basic functions of entering, handling, or facilitating an order, regardless of who was performing those functions or how the order was to be executed, and was not intended to create any further limitations. We have amended section 3.2(1) of the 2008 Policy accordingly.*

**C. "Mixed-use" items**

One commenter indicated that the fact that a service may have incidental features that may not be eligible should not mean it cannot be paid for with client brokerage commissions, or that it should be otherwise subject to heightened scrutiny, so long as the adviser's use of the eligible research goods and services or order execution goods and services justifies the payment made. This commenter added that if the value of the non-eligible portion of a mixed-use item is effectively nominal or *de minimis*, advisers should not have to make any allocation between the eligible and ineligible portions.

**Response:**

*The concept of "mixed-use" items included in subsection 3.4 of the Companion Policy does not prevent a purchaser from obtaining mixed-use items through brokerage transactions involving client brokerage commissions. In addition, the guidance included in the Companion Policy does not preclude an adviser from assigning a zero value to an ineligible portion of a mixed-use item, when it can reasonably justify doing so based on the results of an allocation assessment described in subsection 3.4(2) of the Companion Policy.*

**II. APPLICATION OF THE INSTRUMENT**

**A. Application to trades in futures**

Two commenters requested clarification as to whether trades in futures are included under the 2008 Instrument, and not simply shares as in the U.S. and U.K.. One of these commenters suggested excluding trades in futures from the application of any final instrument on the basis that they are excluded in other jurisdictions, and would increase compliance costs for Canadian advisers and create an un-level playing field. This commenter felt that client interests regarding such products are adequately addressed by the general duty for advisers to deal fairly, honestly, and in good faith with clients.

**Response:**

*Section 2.1 of the 2008 Instrument stated that the "Instrument applies to...any trade in securities...where brokerage commissions are charged by a dealer". The Instrument was intended to apply to trades in a futures contract to the extent that the futures contract would meet the definition of a security, and brokerage commissions were charged in connection with the trade (i.e., a commission or similar transaction-based fee has been charged for a trade where the amount paid for the security is clearly separate and identifiable).*

*Given that in certain jurisdictions, the definition of "security" does not include futures contracts, changes have therefore been made to Part 1 of the Instrument to clarify this intention, and to reflect the CSA's view that the same conflicts and issues arise, regardless of the type of security involved.*

**B. Limitation of instrument to trades where brokerage commissions are charged**

One commenter suggested that the negative language in subsection 2.1(2) of the 2008 Policy regarding principal transactions could be made more useful if instead it was made into the more positive statement that advisers should look to the proposals in determining how to meet their standards of care in relation to principal transactions, given the general principles could be used as guidance for such transactions.

Another commenter was generally concerned with the lack of clarity regarding a manager's obligation to disclose other services received as a result of trades conducted on a principal basis. This commenter suggested that managers do have a responsibility to disclose to clients whatever information is available, and that such disclosure might include: a listing and description of the services received in conjunction with principal trades; an estimate of the total execution cost of principal trades based on industry estimates of average spreads for such trades; and an implicit estimate of the range of value attributable to the non-execution services received.

**Response:**

*We have amended the guidance in subsection 2.1(2) of the Companion Policy to add that an adviser that obtains goods and services other than order execution in conjunction with principal trades where an embedded mark-up is charged 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, in our view, an adviser should consider the goods and 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.*

*However, the Instrument does not expressly prohibit an adviser from obtaining goods and services other than order execution in conjunction with a principal trade where the amount paid for the security is not clearly separate and identifiable (e.g., because a mark-up is embedded in the total amount charged). Should an adviser decide to obtain goods and services other than order execution in conjunction with such trades, we note that it may be more difficult for an adviser to satisfy itself, and demonstrate, that it has met its duty to deal fairly, honestly, and in good faith with its clients, and its obligation to make reasonable efforts to achieve best execution, if it does not have sufficient information regarding the amount of an embedded mark-up that might have been charged in aggregate for the execution and additional goods and services obtained.*

*In addition, an adviser that obtains goods and services other than order execution in conjunction with such a trade outside of the Instrument 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 and services other than order execution in conjunction with such transactions. For example, we note that in connection with the conflict of interest provisions included in section 13.4 of NI 31-103 – Registration Requirements and Exemptions, an adviser would have to consider issues such as how to control the existing or potential conflicts of interest associated with the use of client assets in such a manner, and whether and what disclosure it might need to provide to clients regarding the nature and extent of the conflicts of interest.*

*We will continue to monitor the use of such principal trades to obtain goods and services other than order execution, and will consider whether the Instrument should be amended in the future to bring such trading within the scope of the Instrument.*

**C. Application to unsolicited goods and services**

One commenter questioned whether the 2008 Instrument would capture companies that have made a policy decision not to use “soft dollars” and to pay basic order execution prices. This commenter suggested that in such cases, brokers often still provide unsolicited research goods and services, that are then used, and questioned whether this would mean the adviser would now need to implement expensive systems and a number of policies and procedures to deal with the conflict of interest and the requirements of the 2008 Instrument.

Another commenter suggested that an adviser should not be required to identify, allocate cost to and/or pay for with its own funds, any unsolicited services received, whether or not used, so long as the dealer is providing such services to all of its clients on the same basis regardless of the commission rates charged. Another commenter making the same suggestion added that it should instead be the dealers’ responsibility to track what is offered for free.

Those two commenters also suggested that it did not appear that dealers are permitted to provide “free” services to their clients under the 2008 Instrument, which is important for attracting business. In addition, they added that it may not be cost effective for a dealer to remove embedded services/applications that may help with administrative functions rather than give it away for free, nor would it be practical for advisers to track all the services received, value which ones are used, and restrict the internal usage of those they are not valuing and/or paying for.

Another commenter requested clarification on what constituted “use” of permitted goods and services in the context of the guidance in subsection 4.1(4) of the 2008 Policy. This commenter questioned whether advisers can attribute a nil value to unsolicited research, even when read by staff, and suggested that more guidance on the CSA’s expectations for tracking, using and valuing unsolicited research was needed.

**Response:**

*For purposes of determining whether or how goods and services used by the adviser that were received on an unsolicited basis should be considered under the Instrument, the guidance under subsection 4.1(5) of the Companion Policy provides the ability for the adviser to apply a more principles-based approach.*

*The guidance in the Companion Policy has been amended to clarify that an adviser that 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.*

*We believe this approach provides flexibility to allow an adviser to make a determination regarding the treatment of unsolicited goods and services based on the specific circumstances.*

*From the dealer's perspective, the Instrument does not prohibit a registered dealer from providing goods and services on an unsolicited basis.*

**D. Application to foreign advisers and sub-advisers**

One commenter stated that it would be unreasonable and impractical to impose the requirements of Proposed NI 23-102 on foreign advisers, particularly those under the jurisdiction of the SEC or the FSA. Another added that to do so would increase costs associated with using foreign sub-advisers, which may result in increased management fees for clients, and could effectively reduce access to international expertise.

Another commenter that supported the view that Canadian investors should enjoy the same protections whether they are dealing with domestic or foreign advisers, indicated that it may not be practical, however, for a foreign adviser to comply with both their local requirements and their Canadian requirements if the two conflict. This commenter suggested that foreign advisers should have the option to comply with their local requirements provided that they make disclosure of that fact to potential investors, similar to a requirement proposed for NI 31-103 that foreign advisers disclose their use of an exemption from the Canadian rules to their Canadian clients.

Another commenter indicated that they welcomed a flexible approach regarding the application of a given regulatory regime, and that the ability to select a particular regulatory framework should be predicated on there being a reasonable relationship between the parties to the regulated arrangement and the jurisdiction whose regulations are sought to be applied – for example based on principal place of business or residence of the parties or location where services are delivered.

**Response:**

*Subsection 2.1(1) of the 2008 Policy included a statement to clarify that the Instrument applies to advisers and registered dealers, and that the reference to "advisers" includes registered advisers and registered dealers that carry out advisory functions but are exempt from registration as advisers. A foreign adviser or sub-adviser not required to register in Canada by virtue of an exemption was not intended to be subject to the Instrument.*

*Amendments have been made to Part 1 of the Instrument that should clarify this intention.*

*We note that the question in the 2008 Notice was raised to solicit feedback on whether an adviser should have the flexibility to comply with the disclosure requirements of another regulatory jurisdiction.*

**E. Application to foreign dealers**

One commenter requested clarification regarding the application of the 2008 Instrument to non-Canadian registered dealers. This commenter indicated that it was unclear whether it would apply to foreign dealers registered in a Canadian jurisdiction, particularly for those cases where the foreign dealer has an arrangement with a foreign adviser servicing both Canadian and non-Canadian clients. This commenter suggested providing guidance that would allow any final instrument to apply only to goods and services provided to Canadian advisers, on the basis that the foreign dealer would not ordinarily be in a position to know whether any good or service provided to a foreign adviser involves the use of commissions generated from trades executed for Canadian clients.

**Response:**

*Section 2.1 of the Instrument indicates that the Instrument applies to registered dealers. This would therefore include foreign dealers registered in a Canadian jurisdiction.*

*We note that Part 5 of the Instrument would provide a foreign dealer registered in Canada, that believes it has just cause to be exempted from the Instrument, in whole or in part, with an opportunity to apply for such an exemption, subject to such conditions or restrictions as may be imposed in any such exemption.*

**III. OBLIGATIONS UNDER THE INSTRUMENT**

**A. Obligations of advisers**

*(i) Allocation of benefits to clients*

Two commenters requested further clarification on the first sentence of subsection 4.1(3) of the 2008 Policy which stated that “A specific order execution service or research service may benefit more than one client, and may not always directly benefit each particular client whose brokerage commissions were used as payment for the particular service.” One commenter specifically sought confirmation that “directly” does not infer an intangible benefit that the investment adviser may not be capable of identifying, while the other suggested amendments to clarify that the benefit to clients can occur “over time”.

Two others commented on the second sentence of subsection 4.1(3) of the 2008 Policy which stated that “... the adviser should have adequate policies and procedures in place to ensure that all clients whose brokerage commissions were used as payment for these goods and services have received fair and reasonable benefit from such usage.” One commenter suggested that a general statement should be added to clarify that where an investment fund is concerned, the client generating the brokerage commissions is the fund as a whole and not the individual investor. The other suggested that the standard “fair and reasonable benefit” is unrealistic given that research services typically benefit clients generally, because it is difficult, if not impossible, to track benefits to specific clients.

**Response:**

*The statement in subsection 4.1(3) of the 2008 Policy that included the word “directly” was intended to acknowledge concerns of some of the commenters to the 2006 Instrument that goods and services received typically benefit a number of clients, and may not always be specifically matched to each client account generating the commissions. The difficulties in matching goods and services paid for to each client account is also the reason why advisers should have adequate policies and procedures in place, and apply those policies and procedures, so that, over time, all clients receive fair and reasonable benefit.*

*We agree that these benefits can occur “over time” and have amended subsection 4.1(4) of the Companion Policy accordingly (formerly subsection 4.1(3) of the 2008 Policy).*

*We do not think that, for purposes of the guidance in subsection 4.1(4) of the Companion Policy, it would make any difference whether the adviser were to consider the client to be the investment fund or the individual investors in the fund, as the benefit to the fund should represent the sum of the proportional benefit conferred on the individual investors in the fund.*

**B. Obligations of Dealers**

Two commenters requested clarification on the proposed obligations for dealers, and the expected level of due diligence to be performed by dealers in meeting their obligations when assessing the eligibility of goods and services being paid for through brokerage transactions involving client brokerage commissions, given that in many cases, the dealer will never see the end product provided by a third-party service provider, and will not know how it is used by the adviser. These commenters felt that in most cases the consumer of the service was the only person that could provide a meaningful evaluation.

As a result, these commenters suggested that due diligence should only be required to be performed by dealers on services that are proposed, sponsored or offered by the dealer to the adviser. It was also suggested that dealers should only be responsible for ineligible uses or payments if the dealer had actual or constructive knowledge, or ought to have known, of the ineligibility.

**Response:**

*The Instrument indicates that dealers 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 or research goods and services.*

*To meet this obligation, we would expect that a dealer, in conjunction with a trade that is subject to the Instrument, would have to make an assessment that the goods and services being paid for, or for which it has been asked to pay for, meet the definitions of order execution goods and services or research goods and services. We have amended section 4.2 of the Companion Policy to reflect this view.*

*We think that a dealer should be able to identify when a good or service clearly does not meet the definition of order execution goods or services or research goods and services, including when it has been asked by an adviser to pay a third-party invoice. When it is not clear as to whether the good or service meets one of the definitions, or when the description on the invoice is insufficient to determine the nature of the good or service, an inquiry should be made with the adviser before accepting payment or agreeing to pay.*

**IV. DISCLOSURE**

**A. Narrative disclosure**

*(i) General*

One commenter strongly agreed with the focus on narrative disclosure requirements regarding the nature and scope of services received. This commenter also noted that the SEC had proposed amendments to its Form ADV subsequent to the publishing of the 2008 Instrument, and suggested that the narrative disclosure should include a meaningful discussion of the potential conflicts of interest, as was included in the proposed Form ADV. Another commenter suggested that the current and proposed Form ADV qualitative disclosure regime of the SEC clearly addresses the CSA's goal of increased transparency and accountability with respect to brokerage commission practices.

**Response:**

*For purposes of the disclosure requirements in the Instrument, we have not specifically required explicit statements regarding the conflicts of interest that arise when an adviser obtains goods and services other than order execution in connection with client brokerage commissions.*

*However, we note that subsection 13.4(3) of NI 31-103 requires disclosure, in a timely manner, of the nature and extent of the conflict of interest to the client whose interest conflicts with the interest identified, if a reasonable investor would expect to be informed of a conflict of interest identified under subsection 13.4(1) of NI 31-103. The guidance provided in section 13.4 of the Companion Policy 31-103CP indicates that, among other things, the disclosure should explain the conflict of interest and how it could affect the service the client is being offered.*

*In our view, under subsection 13.4(3) of NI 31-103, an adviser should also explicitly identify and explain the conflicts of interest inherent when obtaining goods and services other than order execution in connection with client brokerage commissions, and how those conflicts could affect the service the client is being offered.*

*(ii) Disclosure of dealer and third-party suppliers, along with types of goods and services*

Four commenters raised concerns with the proposed requirement in paragraph 4.1(c) of the 2008 Instrument to disclose the names of dealers and third-party suppliers, and the types of goods and services provided.

Three of these commenters generally were of the view that it would be unduly cumbersome and burdensome to produce such lists, particularly if produced at anything other than the firm-wide level, and questioned the utility to clients, for example given each manager may utilize different services for each client account or the same series of services for all client accounts. One of these commenters suggested that a general description of the goods and services received, and the types of broker-dealers utilized would be sufficient for clients.

The other of the four commenters referred to above raised concerns relating to competitive advantage, suggesting that disclosure of the suppliers and the nature of the goods and services received constitutes proprietary competitive information. This commenter believed the likelihood of the disclosure becoming public was relatively high, and suggested making this disclosure item an "upon request" requirement to allow for the privacy of information, while making the disclosure more meaningful as a client will make such a request only if they consider it to be important. This commenter also noted that disclosure requirements similar to those proposed in paragraph 4.1(c) of the 2008 Instrument currently exist for mutual funds under Form 81-101F2, and suggested that adopting a different "upon request" approach for any final instrument could be justified for pooled funds, as these private funds are sold to accredited investors and not to the general public, as are mutual funds.

**Response:**

*We continue to believe that clients would find disclosure of the types of goods and services acquired in connection with brokerage transactions involving client brokerage commissions to be useful information. Subsection 5.3(4) of the Companion Policy continues to include guidance that the 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.)*

*Based on the comments received, we agree that, for some clients, disclosure of a list of dealers and third-party suppliers may not be useful information. As a result, we have amended the Instrument to reflect an 'upon request' approach to the disclosure of the names of dealer and third-party suppliers, except in relation to affiliated entities.*

*Given the conflicts of interest inherent in any dealings involving affiliated entities, we continue to believe that the names of affiliated entities and the types of goods or services each such entity provided should be separately identified and disclosed to all clients, at least annually. This disclosure should not only assist with the identification of potential conflicts of interest, but should also increase accountability on the part of the adviser in relation to such dealings.*

*Amendments are being proposed to Form 81-101F2 – Contents of Annual Information Form and Form 41-101F2 – Information Required in an Investment Fund Prospectus to require narrative soft dollars disclosure for investment funds that is similar to the disclosure required under Part 4 of the Instrument.*

**B. Quantitative disclosure**

*(i) General*

Most of the commenters raised general questions or concerns with the quantitative disclosure requirements proposed in paragraph 4.1(g) of the 2008 Instrument that would require advisers to make, on an aggregated basis, a reasonable estimate of the portion of those aggregated commissions representing the amounts paid for goods and services other than order execution. Of less concern was the disclosure of total client brokerage commissions proposed in paragraph 4.1(f). Commenters generally questioned the usefulness to clients and need for the proposed quantitative disclosure, and raised concerns with the difficulties and costs associated with meeting these requirements. Some of the more specific comments provided are as follows:

- the bundled nature of proprietary goods and services, and the differing levels of information that may be provided by willing dealers, will lead to subjectivity and differences in advisers' estimates and estimate methodologies, and will result in disclosure that cannot be compared across advisers, and may be confusing or even meaningless for investors;
- it may not be possible to obtain the necessary information from sub-advisers to meet the disclosure requirements, when those sub-advisers are not required by the laws in their jurisdiction to maintain such information, or the disclosure would likely be inconsistent between advisers as a result of the differing levels of information likely to be received from sub-advisers;
- experience in the U.K. with the IMA Pension Fund Disclosure Code suggests that without a methodology provided for estimating research and execution costs, advisers have adopted varied and inconsistent methodologies – for example, by valuing research and deeming the remainder execution; by valuing execution and deeming the remainder research; or estimating the cost to reproduce the research;
- quantification of the components of bundled commissions will be difficult, and therefore costly;
- the actual cost of trade execution has so many variables that it is practically impossible to individually value them on a per trade basis;
- both advisers and dealers view the costs of trading as relationship pricing where services are often offered as part of an overall package, making value very subjective;
- it would be unworkable for small firms, and extremely difficult for even the larger firms, to accurately allocate commissions;
- new systems would be required to track and value the commission usage, and any differences in disclosure requirements between Canada and the U.S. may add further complications or costs for advisers doing business in both jurisdictions;

- the majority of jurisdictions cited in IOSCO's report *Soft Commission Arrangements for Collective Investment Schemes* issued in November 2007 did not appear to require the quantitative disclosure proposed in the 2008 Instrument;
- many clients do not typically request from their advisers, and are not interested in receiving, the type of information proposed to be disclosed; and
- experience in the U.K. has shown that even the most sophisticated investors are not using the disclosure provided, and the movement in the U.S. is towards refocusing on what questions should be asked rather than prescribing standard industry disclosure.

Generally, many of the commenters suggested that if the quantitative disclosure requirements proposed in the 2008 Instrument were to be approved, then a requirement should be imposed on dealers to provide advisers with estimates of the costs of goods and services provided in addition to the execution cost of trades (whether as a dollar amount or a percentage), as they are in a much better position to estimate such costs. Various commenters also suggested alternatives to the proposed quantitative disclosure requirements that they thought may be more useful for clients, as follows:

- disclosure of just the total brokerage commissions paid by the client, and an aggregated total of client brokerage commissions paid;
- disclosure of an aggregate percentage of client brokerage commissions associated with the payment made for independent third-party research and other services on a firm-wide basis, or disclosure of a ratio of total firm-wide commission costs to the assets managed, instead of disclosure of the aggregate commissions paid by the firm across all accounts which could result in the disclosure of confidential and proprietary information, and adversely impact an adviser's business;
- disclosure of the total amount of soft dollar expenses in relation to metrics such as total assets under management or total commissions paid;
- disclosure of an investment fund or account's portfolio turnover rate and trading expense ratio, as is currently required for investment funds under NI 81-106; and
- quantification of only the third-party goods and services, with payments for independent third-party research goods and services and goods and services being tracked across client accounts individually and across the firm in aggregate.

**Response:**

*Based on the comments received and in light of developments in the U.S., including the proposed amendments to the SEC's Form ADV<sup>5</sup>, we have decided not to proceed with quantitative disclosure requirements at this time.*

*We will continue to monitor industry developments and developments in other regulatory jurisdictions to determine whether it might be appropriate to propose quantitative disclosure requirements at some point in the future.*

*In the interim, we believe that the narrative disclosure requirements will help to provide useful information to clients, and to increase accountability on the part of advisers.*

(ii) 'Reasonable estimate' standard

Five commenters raised specific concerns with the 'reasonable estimate' standard proposed under paragraph 4.1(g) of the 2008 Instrument relating to the estimation of the portion of aggregated client brokerage commissions representing amounts paid for goods and services other than order execution. These commenters were generally of the view that the more appropriate standard would be that currently included in NI 81-106, which requires quantification of the amount paid for goods and services other than order execution "to the extent the amount is ascertainable". The reasons for this view included:

- a 'reasonable estimate' standard may not be feasible, as evidenced by the vast majority of fund companies taking the view that proprietary research cannot be valued for purposes of disclosure under the lower 'ascertainable' standard in NI 81-106;
- the standard for investment funds requires disclosure if the adviser can obtain information about costs, and does not require a "guess" as to the amounts to use when otherwise unable to obtain the needed information; and

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<sup>5</sup> The SEC proposed amendments to Form ADV on March 3, 2008 under Release No. IA-2711; 34-57419; File No. S7-10-00.

- funds have already built systems and developed reporting to comply with the NI 81-106 standard, and to meet the 'reasonable estimate' standard, a model will have to be created that ties to accounting records, and that can be supported and audited.

In addition to the general view that the 'ascertainable' standard of NI 81-106 should instead be adopted, one of the commenters suggested also adopting a position similar to that in the *Frequently Asked Questions on National Instrument 81-106* which states that in those cases where an investment fund cannot ascertain the value of the soft dollar portion, a statement should be included in the notes indicating that the soft dollar portion is unascertainable.

One other commenter suggested that if the CSA proposed to maintain the 'reasonable estimate' standard, that guidance would be needed on how this should be estimated given the above-mentioned view of the majority of fund companies that proprietary research cannot be valued. If, instead, an 'ascertainable' standard is adopted, this commenter suggested completely deleting any requirement for the disclosure of the value of any portion of research, as disclosing the value of this research, but not the value of proprietary research, creates an unlevel playing field between these two types of research based on source, and may provide incentives for advisers to send trades to dealers for reasons other than best execution. This commenter also argued that in its own experience, quantifying only third-party research would significantly understate soft dollar use and be highly misleading to investors.

Two commenters suggested that the related investment funds disclosure contained in NI 81-101 and NI 81-106 should be made consistent with the disclosure included in any final instrument, regardless, in order to avoid increased costs, compliance burdens, and confusion.

**Response:**

*As noted earlier, we have decided not to proceed with quantitative disclosure requirements at this time.*

*We note that investment funds should refer to the quantitative disclosure requirements under NI 81-106 and the related guidance in Companion Policy 81-106CP, and to the additional information provided in CSA Staff Notice 81-315 – Frequently Asked Questions on National Instrument 81-106 Investment Fund Continuous Disclosure.*

*The quantitative disclosure requirements applicable to investment funds under subparagraph 3.6(1)3 of NI 81-106 have been maintained. The reasons for maintaining these requirements include that disclosure under NI 81-106 would not only inform, to the extent ascertainable, the amount of commissions paid for goods and services other than order execution, but would also provide information relevant to other amounts disclosed under NI 81-106, such as the trading expense ratio (which expresses portfolio transaction costs as a percentage of net assets), and that NI 81-106 applies to a narrower scope of advisers (i.e., applies to advisers to an investment fund).*

(iii) *Presentation of quantitative disclosure – Comments on Question 2 from the 2008 Notice*

*Question – What difficulties might be encountered by requiring the estimate of the aggregated commissions to be split between order execution and goods and services other than order execution? What difficulties might be encountered if instead the requirement was for the aggregate commissions to be split between research goods and services and order execution goods and services?*

Most commenters' responses to this question focused on their concerns with the proposed quantitative disclosure, and the inherent difficulties in making any quantified estimates when bundled goods and services are involved. These concerns were discussed in more detail above in section B of this Part IV.

Of those commenters that did specifically address the subject of this question, two commenters did not see many difficulties with estimates being made based on a split between order execution and goods and services other than order execution. One of these commenters suggested that advisers could make this estimate by applying an average of the "execution-only" rates being charged by dealers, against trading volumes, with the remainder representing research and brokerage services over-and-above "execution only", which could then be split out further.

Another commenter suggested splitting trading cost estimates into execution-only costs, research services costs, and order execution services costs that add to the proficiency of the trade execution process, but noted that any such estimates may be difficult as execution-only costs vary from trade to trade because dealers have different cost structures, and the nature and difficulty of specific trades will vary. However, this commenter did not think that the fact that any quantitative disclosure would involve estimates was a valid reason for not making the disclosure. This commenter also added that as execution-only trading becomes more prevalent, industry standards for execution-only costs will be established for purposes of making the split.

Two commenters, however, argued that there is no standard “execution-only” commission rate that could be used to value execution services and indirectly derive the value of all other services given the variety of factors impacting a particular trade.

**Response:**

*As noted earlier, we have decided not to proceed with quantitative disclosure requirements at this time.*

*We note that investment funds should refer to the quantitative disclosure requirements under NI 81-106 and the related guidance in Companion Policy 81-106CP, and to the additional information provided in CSA Staff Notice 81-315 – Frequently Asked Questions on National Instrument 81-106 Investment Fund Continuous Disclosure.*

**C. Other specific comments relating to disclosure**

- (i) *Flexibility to follow disclosure requirements of another regulatory jurisdiction – Comments on Question 3 from the 2008 Notice*

*Question – As order execution goods and services and research goods and services are increasingly offered in a cross-border environment, should the Proposed Instrument allow an adviser the flexibility to follow the disclosure requirements of another regulatory jurisdiction in place of the proposed disclosure requirements, so long as the adviser can demonstrate that the requirements in that other jurisdiction are, at a minimum, similar to the requirements in the Proposed Instrument? If so, should this flexibility be solely limited to quantitative disclosure given that the issues associated with differences in quantitative disclosure requirements between regulatory jurisdictions are likely greater than the problems associated with differences in narrative disclosure requirements? In addition, should there be limitations on which regulatory jurisdictions an adviser may look to for purposes of identifying suitable alternative disclosure requirements and, if so, which jurisdictions should be considered eligible and why?*

Nine commenters were generally of the view that flexibility should be provided to allow an adviser to follow the disclosure requirements of another jurisdiction in place of the disclosure requirements for any final instrument. Reasons provided included that it would alleviate any additional burden that might be caused by the indirect imposition of disclosure requirements on foreign sub-advisers not otherwise subject to a final instrument. One of these suggested that if such flexibility was permitted, an adviser should not be permitted to provide disclosure that is at a lower standard than that proposed in the 2008 Instrument (i.e., the most restrictive standard should be applied). Others suggested that advisers should be permitted to follow the disclosure requirements of the SEC or the IMA Disclosure Code in the U.K. One commenter indicated that the CSA should determine and communicate which jurisdictions’ disclosure requirements are acceptable, with another suggesting that the adviser should be left to make that determination.

Four commenters were generally of the view that allowing such flexibility should either not be considered or should be approached with caution. Reasons for this view included:

- differences in requirements in other jurisdictions would affect the comparability of disclosure, and may result in disclosures that are more difficult for clients to comprehend;
- clients should receive the disclosure that the jurisdiction they live in requires;
- there could be significant and unproductive disagreement between the CSA and advisers over which foreign disclosure regimes would be considered similar for purposes of the proposed disclosure requirements; and
- it may cause market participants to be incentivized to execute trades in different jurisdictions in order to provide lesser disclosure to clients.

One commenter that was not in favour of permitting flexibility suggested greater harmonization between the disclosure requirements of any final instrument and the SEC requirements, to allow for greater comparability between Canadian and U.S. advisers. Similar sentiments regarding the adoption of the SEC’s disclosure requirements were echoed by two other commenters in different contexts.

Another commenter did not comment on the approach, on the basis that they would require more information on how ‘similarity’ between jurisdictions would be determined, if the CSA did not identify the jurisdictions considered similar for the purpose of disclosure.

**Response:**

*Given that we have decided not to proceed with quantitative disclosure requirements at this time, we think it is no longer necessary to consider whether advisers should be permitted to follow disclosure requirements of another jurisdiction.*

*We note that investment funds should refer to the quantitative disclosure requirements under NI 81-106 and the related guidance in Companion Policy 81-106CP, and to the additional information provided in CSA Staff Notice 81-315 – Frequently Asked Questions on National Instrument 81-106 Investment Fund Continuous Disclosure.*

(ii) *Customization of disclosure*

One commenter requested whether disclosure could be generic and non-customized for each individual client, indicating that the proposed disclosure in paragraphs 4.1(c) and (f) of the 2008 Instrument, at a minimum, would have to reflect an individual client's situation and may be more onerous than the CSA anticipates.

**Response:**

*As noted earlier, we have decided not to proceed with quantitative disclosure requirements at this time. We have added guidance to subsection 5.3(1) of the Companion Policy to clarify that 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.*

*We note that investment funds should refer to the quantitative disclosure requirements under NI 81-106 and the related guidance in Companion Policy 81-106CP, and to the additional information provided in CSA Staff Notice 81-315 – Frequently Asked Questions on National Instrument 81-106 Investment Fund Continuous Disclosure.*

(iii) *Initial disclosure*

One commenter requested clarification regarding the exact disclosure to be given to new clients of an adviser, given that there will be no disclosure available for that new client under paragraph 4.1(f) of the 2008 Instrument, and there is question as to what might be relevant for a new client in relation to paragraphs 4.1(c) and (g). This commenter suggested breaking Part 4 of the 2008 Instrument into two separate subsections delineating the requirements for initial and annual disclosure, with the initial disclosure being comprised of only paragraphs (a), (b), (d) and (e), and the annual disclosure being comprised of the whole of the proposed section 4.1.

**Response:**

*In accordance with the comments received, we have amended Part 4 of the Instrument to clarify the disclosure to be provided on an initial and periodic basis. We think this will reduce any confusion in relation to the intended application of the requirements, and reflect that it might not always be relevant for a new client to receive disclosure of the types of goods and services previously disclosed by the adviser to other clients.*

(iv) *Guidance relating to disclosure to the Independent Review Committee*

Four commenters had concerns with the guidance provided in section 5.1 of the 2008 Policy regarding conflicts of interest and the possibility for disclosure to be made under any final instrument to a fund's Independent Review Committee (IRC).

All four generally questioned the appropriateness of the guidance itself, and whether and why it might be more appropriate for disclosure to be made to the IRC in those cases where the adviser to an investment fund is also the trustee and/or manager of the fund, or an affiliate of either, and some indicated that the guidance provided suggested disclosure to the IRC in these cases was required. Comments on the guidance included the following:

- disclosure to the IRC is not necessary if any conflict relating to the use of client brokerage commissions is mitigated by virtue of following the requirements of any final rule;
- NI 81-107 does not create different rules based on whether the fund manager is also the trustee, nor does it prescribe what constitutes a conflict of interest, leaving this determination to the adviser/manager;

- a requirement that a determination be made by the manager as to whether there is a conflict of interest matter requiring the disclosure information be provided to the IRC should not be embedded in proposed NI 23-102, whose primary purpose is not related to IRCs; and
- if the IRC is expected to assess whether the commissions paid achieve “a fair and reasonable result” – that is, expected to assess an adviser’s business judgment – this would be inconsistent with section 5.1 of NI 81-107 which indicates that “the CSA do not consider it the role of the IRC to second-guess the investment or business decisions of a manager...”.

Three of these commenters generally were of the view that any reference to the IRC and NI 81-107 should be deleted from any final companion policy, and replaced with either a provision allowing advisers the discretion to determine which fund oversight body should receive the disclosure, or with a requirement for the required disclosure to be made in the Annual Information Form required under NI 81-101.

**Response:**

*We agree that the reference to the IRC should be removed from the Companion Policy on the basis that the requirements of, and related commentary to, NI 81-107 provide adequate guidance on the types of conflict of interest matters that should be referred to the IRC for its review and decision.*

*It should be noted, however, that Section 5.1 of NI 81-107 requires that a manager refer all conflict of interest matters to the IRC for its review and decision, regardless of whether the manager believes the conflict has been sufficiently mitigated through compliance with any final rule. Guidance has been provided in the commentary to NI 81-107 that would suggest that conflict of interest matters subject to IRC review and decision might include conflicts relating to the trading practices of the investment funds, including the negotiation of soft dollar arrangements with dealers with whom the adviser places portfolio transactions for the investment fund.*

(v) *Disclosure in the case of a pooled fund*

Two commenters requested clarification as to whether it would be sufficient to disclose the total brokerage commissions paid at the pooled fund level, for purposes of the client-level disclosure requirement under paragraph 4.1(f) of the 2008 Instrument. These commenters indicated it would be difficult to attribute pro rata commission amounts to each client (unitholder), as it would require a daily analysis of each client’s pro rata holding given to account for changes in any particular client’s account holdings.

Another commenter requested that similar clarification be provided regarding the proposed disclosure as a whole, suggested that disclosure should be made on a fund-by-fund basis for pooled funds, as is the case for publicly offered investment funds.

**Response:**

*As noted earlier, we have decided not to proceed with quantitative disclosure requirements at this time. For the remaining narrative disclosure requirements, there is nothing in the Instrument or Companion Policy that would preclude an adviser from providing disclosure at the pooled fund level to clients.*

(vi) *Disclosure of sub-adviser commission usage*

One of the commenters questioned whether the CSA could mandate in a companion policy that disclosure by advisers must include commissions paid on brokerage transactions that might be directed by sub-advisers. Issues were also raised by some commenters with the practicality of obtaining disclosure from sub-advisers given there is no obligation (other than contractual) on those sub-advisers to provide such disclosure. A few of the commenters raised concerns as to whether such contracting could even be achieved, particularly for unrelated foreign sub-advisers, and suggested it may not even be possible to obtain the necessary information when sub-advisers are not required by the laws in their jurisdiction to maintain it, and disclosure would likely be inconsistent between advisers as a result of the differing levels of information likely to be received from their sub-advisers.

One of these commenters suggested that if the guidance was not changed, the disclosure requirements should be made to be identical to the requirements of the other countries, or Canadian advisers should be permitted to disclose only that information provided to them by a sub-adviser where there is also a disclosure requirement in the sub-adviser’s jurisdiction. Another two commenters cautioned that the proposed guidance might cause some sub-advisers to choose not to do business with Canadian advisers, particularly if Canada is a small market for them.

**Response:**

*Subsection 5.3(1) of the 2008 Policy stated “For the purposes of the disclosure made under section 4.1 of the Instrument, the requirement on the adviser to provide disclosure regarding the use of its client brokerage commissions would include the use of those commissions by its sub-advisers.”*

*We have revised subsection 4.1(1) of the Instrument to clarify that an adviser must provide the required 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. The guidance provided in subsection 5.3(1) of the Companion Policy has also been amended to clarify the expectation that 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.*

*As noted earlier, we have decided not to proceed with quantitative disclosure requirements at this time. As a result, we believe that the primary concerns expressed in relation to disclosure when a foreign sub-adviser is involved have been mitigated. We do not believe that obtaining the information to meet the narrative disclosure requirements should present the same level of difficulty, nor do we believe it is unreasonable for such disclosure to be provided by the adviser.*

**V. TRANSITION PERIOD**

**A. Transition period length – Comments on Question 4 from the 2008 Notice**

*Question – Should a separate and longer transition period be applied to the disclosure requirements to allow time for implementation and consideration of any future developments in the U.S.? If so, how long should this separate transition period be?*

Four commenters suggested that the transition period was adequate, with one of these noting that the proposed time period was similar to that allowed when similar proposals were implemented in the U.K. and U.S. Two of these commenters also suggested that future regulatory developments in the U.S. or FSA could be addressed as they arise.

One commenter suggested that a relatively short transition period would be appropriate only if the quantitative disclosure requirements were reduced to just aggregated commission disclosure, or if the CSA did not expect advisers to take extraordinary efforts in preparing their “reasonable estimates” for purposes of the quantitative disclosure requirements.

The majority of commenters did not believe that the proposed transition period was adequate. Reasons for this view included that:

- systems would need to be changed or implemented in order to meet the proposed quantitative disclosure requirements;
- a full reporting cycle would have to pass in order to collect the data required to be disclosed; and
- the disclosure requirements in the U.S. have not yet been finalized, and the proposed transition period did not allow for consideration of the impact of any difference in disclosure requirements.

Four of these commenters suggested that a transition period ranging from 12 to 24 months would be appropriate. Another five commenters suggested either waiting until the SEC published and/or finalized its own proposals, or at least allowing for enough time to take any SEC proposals into account (i.e., by setting a transition period after discussion with the SEC, by setting a separate transition period for the proposed disclosure requirements that would apply to the first fiscal year-end commencing at least six months after the effective date of any U.S. rule on client brokerage commission disclosure, or by delaying the adoption of the disclosure portion of any final instrument until the SEC had finalized its own proposals). Another two commenters suggested that advisers should be given until their next annual information statement, or until the following one if the first fell within six months of the finalization of any rule. Another of these commenters suggested that if a separate longer transition period was to be applied to the disclosure requirements, a reasonable transition period for the non-disclosure requirements might be the six months proposed in the 2008 Instrument, but a more appropriate transition period for these requirements might be to apply these to the first fiscal year that commences at least six months after the effective date of any final instrument, to allow for better comparability across firms, and for advisers to have the option of providing the disclosure in conjunction with other client reporting.

**Response:**

*As noted earlier, the Instrument does not include quantitative disclosure requirements. As a result, we believe a six month transition period is adequate.*

**B. Effect of transition period**

One commenter questioned whether instead of an effective date of six months from its approval, the final rule should become effective immediately but with an appropriate transition period for purposes of compliance with its requirements, as would be consistent with the approach taken by the CSA in relation to the introduction of other rules.

**Response:**

*Section 6.1 of the Instrument states that the Instrument will come into force on June 30, 2010. This provides for a transition period before compliance with the Instrument becomes mandatory.*

**C. Status of Existing Policies**

One commenter questioned whether OSC Policy 1.9 and AMF Policy Statement Q-20 would be revoked at the end of the transition period.

**Response:**

*OSC Policy 1.9 and AMF Policy Statement Q-20 will be rescinded on June 30, 2010.*

**VI. OTHER COMMENTS / REQUESTS FOR CLARIFICATION**

**A. Lack of explicit link to 'best execution' obligations**

One commenter suggested that the link between the use of client brokerage commissions and 'best execution' should be written into any final rule, and noted that such linkage exists in section 11.6.11 of the FSA's Conduct of Business Sourcebook, and in the SEC Release.

**Response:**

*We agree and have amended Section 1.2 of the Companion Policy to discuss the duty to make reasonable efforts to achieve 'best execution' when acting for a client.*

**B. "Banking" of soft dollar commissions**

One commenter requested clarification as to whether the CSA approves of accumulating soft dollar payments that could be "banked" for future use, and how such payments should be disclosed given that items acquired with those funds would not be easy to link back to commissions that may have been paid in a previous year.

**Response:**

*The concept of a dealer accumulating or pooling portions of commissions, to be later directed by an adviser to acquire goods and services other than order execution was contemplated in paragraph 4.1(g) of the 2008 Instrument, when proposing to require that advisers disclose a reasonable estimate of the portion of the aggregated commissions representing the "amounts paid or accumulated to pay for goods and services other than order execution...".*

*However, the accumulation of balances that go unused, or large balances that are carried forward over long periods of time, would raise questions as to whether the adviser is and has acted in the best interests of its client or clients in relation to the amount of client brokerage commissions paid to dealers. We would think if such situations occur that an adviser would take any actions necessary in relation to the accumulated balances to ensure the interests of its clients are being served.*

*Given that the Instrument does not include quantitative disclosure requirements, we believe the concerns relating to disclosure have been mitigated. We note that the current disclosure requirements under paragraph 3.6(1)3 of NI 81-106 requires disclosure of the amounts paid or payable to dealers for goods and services other than order execution. In our view, amounts payable would include disclosure of the amounts 'banked' as at the reporting date.*

**C. Use of term "third party beneficiaries"**

One commenter recommended replacing the term "third party beneficiaries" in section 2.1 of the 2008 Instrument, with "clients" for consistency, and because certain clients may not be considered third party beneficiaries.

**Response:**

*For consistency, we have replaced "third party beneficiaries" with "client".*

**D. Costs**

Three commenters suggested the CSA's estimates of costs for compliance in relation to the additional burden that would be placed on foreign sub-advisers asked to provide quantitative disclosure information, were greatly underestimated. Two of these indicated that these increased costs for sub-advisers would increase the overall costs to the fund manager, which would therefore increase the cost of obtaining global diversification for Canadian investors.

One of these commenters also suggested that the cost-benefit analysis did not consider the significant implementation and enhancement costs to the investment fund industry, including those to be incurred by those companies that had previously made a policy decision not to use "soft dollars", and was concerned that the estimate was not made based on consultation with Canadian firms, but was extrapolated based on research from other jurisdictions. This commenter also questioned the validity of the scope of the analysis, indicating that it provided cost estimates only for the review of current brokerage arrangements and not, as noted above, for the creation of monitoring systems, for the additional required disclosures, or for other necessary implementation costs. This commenter also added that the analysis failed to meaningfully address the benefits, and cited the IOSCO report – *Soft Commission Arrangements for Collective Investment Schemes* issued in November 2007 that reported that no jurisdictions were able to quantify the number or probability of soft commission abuses occurring in their jurisdictions in the last three years, including Ontario, Quebec, the U.S. and the U.K.

**Response:**

*Given the Instrument has been finalized without quantitative disclosure requirements, we believe the concerns pertaining to the additional burden that might be placed on foreign sub-advisers in relation to such disclosure have been adequately addressed.*

*We also believe that the principles-based approach taken in relation to unsolicited goods and services (see the guidance on unsolicited goods and services in subsection 4.1(5) of the final Companion Policy, and the related discussion in Section C of Part II of this summary of comments) should provide sufficient flexibility to reasonably address the concerns associated with the potential impact of the guidance included in the 2008 Policy.*

*In response to the comment regarding the November 2007 IOSCO report, we note that the report does indicate that none of the surveyed IOSCO jurisdictions were able to quantify any soft-dollar abuses. However, there is the risk that the current lack of clear requirements and guidance in Canada creates uncertainty – one of the anticipated benefits of the 2008 Instrument is that it adds certainty by providing improved guidance to advisers. A lack of clear requirements and guidance could lead to the inadvertent misuse of client brokerage commissions.*

*For example, we note that the Cost-Benefit Analysis published with the 2008 Instrument reports that between 2003 and 2007, OSC compliance staff found deficiencies in 35% of the 31 firms reviewed that purchased third-party products in connection with client brokerage commissions. Over the same period, the British Columbia Securities Commission's compliance staff identified seven deficiencies, only one which they considered serious in 23 Investment Counsel/Portfolio Manager firms that had soft dollar arrangements.*

**E. Harmonization across CSA**

One commenter expressed disappointment that it appeared possible that advisors might be subject to different sets of rules within Canada if the British Columbia Securities Commission did not support the implementation of a National Instrument,

particularly when the purpose of the policy review was to harmonize requirements with those in foreign jurisdictions such as the U.S. and U.K. This commenter added that such lack of consistency among Canadian regulators is confusing to market participants and contributes to a weakening of perception of Canada's capital markets.

Another commenter urged the CSA to move forward with the proposals with a view to ensuring that each jurisdiction passes uniform rules and that staff in each jurisdiction administer and interpret the rules in a uniform and consistent fashion. This commenter added that most securities industry participants in Canada are not "local" market participants, in that they often participate in multiple jurisdictions. This commenter also suggested that to the extent an industry participant chose to operate only in a limited number of provinces or territories, it is generally done to avoid being subject to all regulators and laws of each province and territory. This commenter did not see a need for any local rules or regulation, nor for any need for there to be differing interpretations or administrative positions (particularly unwritten administrative positions). This commenter was also troubled with the position of the British Columbia Securities Commission regarding possible adoption of any final rule, and stated that the prolonged discussions about client brokerage commissions practices by regulators and industry alike, not only in Canada, but also in the U.S. and U.K., demonstrate completely the need for clearly defined rules and regulatory guidance.

**Response:**

*The Instrument has been finalized as a National Instrument and applies in each jurisdiction.*

**List of commenters**

1. Alternative Investment Management Association – Canada Chapter
2. Baillie Gifford & Co.
3. Bloomberg L.P.
4. BNY ConvergEx Group LLC
5. Borden Ladner Gervais LLP
6. Canadian Advocacy Council of CFA Institute Canadian Societies
7. Commission Direct Inc.
8. Fidelity Investments Canada Limited
9. Greystone Managed Investments Inc.
10. Investment Adviser Association
11. Investment Counsel Association of Canada
12. Investment Company Institute
13. The Investment Funds Institute of Canada
14. IGM Financial Inc.
15. Investment Industry Association of Canada
16. Leith Wheeler Investment Counsel Ltd.
17. National Society of Compliance Professionals Inc.
18. RBC Asset Management Inc.
19. Securities Industry and Financial Markets Association
20. TD Asset Management Inc.
21. TD Newcrest

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.

**RESCISSION OF  
ONTARIO SECURITIES COMMISSION POLICY 1.9 – USE BY DEALERS OF BROKERAGE COMMISSION AS PAYMENT  
FOR GOODS OR SERVICES OTHER THAN ORDER EXECUTION SERVICES – (“SOFT DOLLAR” DEALS)**

1. Ontario Securities Commission Policy 1.9 – *Use by Dealers of Brokerage Commission as Payment for Goods or Services other than Order Execution Services – (“Soft Dollar” Deals)* is rescinded on June 30, 2010.