Appendix A
Proposed National Instrument 23-102 *Use of Client Brokerage Commissions as Payment for Order Execution Services or Research*
Cost-Benefit Analysis

Introduction
The Ontario Securities Commission (OSC) is committed to delivering cost-effective regulation. One of the principles identified in the *Securities Act* is that "[b]usiness and regulatory costs and other restrictions on the business and investment activities of market participants should be proportionate to the significance of the regulatory objectives sought to be realized"[1].

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

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

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

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

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

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

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

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

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

The scope of the issue

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

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

The key stakeholders in soft dollar arrangements are:

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

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

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

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

- Investors who use an adviser to manage their portfolio.

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

Regulatory concerns

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

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

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

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

4. The responses to Concept Paper 23-402 *Best execution and soft dollar arrangements* showed that existing requirements are not clear about what can and

[4] This figure represents the number of firms in National Registration Database (NRD) that are registered in an adviser category. Not all of these firms will be portfolio managers; some will just be investment counsel. The NRD information was extracted in January 2006.
[5] This is based upon anecdotal evidence and Greenwich's research that shows that bundled goods and services are far more prevalent (54% of commissions allocated for bundled services as opposed to 11% for third-party research).
[6] Investment Dealers Association of Canada, Securities Industry Performance, Fourth Quarter 2005
[7] OSC Policy 1.9 *Use by Dealers of Brokerage Commission as Payment of goods and Services other than Order Execution Services.*
[8] Policy Statement Q-20 *Use by Dealers of Brokerage Commission as Payment of goods and Services other than Order Execution Services* (which became a rule in June 2003).
[9] From April 2003 until March 2005, the OSC performed compliance reviews of 47 firms registered as investment counsel/portfolio managers (ICPM). 18 of those firms had soft dollar arrangements to purchase third-party goods and services. Of those, deficiencies were found at seven firms.

cannot be purchased with soft dollar commissions. OSC staff often receive inquiries from market participants about permitted goods and services.

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

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

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

Goals of this policy initiative

The policy initiative on client brokerage commissions has four goals:

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

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

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

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

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

Four options

There are four options for addressing soft dollars:

1. Maintain the status quo

2. Update the current requirements

3. Ban the practice

4. Reformulate the current requirements into a National Instrument

1. **Maintain the status quo**

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

   Costs

   - Does not address the potential for conflicts of interest. A continuing lack of meaningful transparency means investors are unable to effectively monitor their adviser's use of brokerage commissions to pay for investment management goods and services.
   - Perpetuates uncertainty about the appropriate uses of soft dollars.
   - Canada would fall further out of step with the international markets it most often interacts with, namely the U.S.A. and the United Kingdom. This could become a competitive disadvantage for Canada's capital markets if other jurisdictions are seen to have tighter controls on the use of brokerage commissions. Canadian investment managers may be less able to attract international investors.

   Benefits

   - No additional costs for dealers and advisers.

2. **Update current requirements**

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

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

   Costs

   - Production and distribution of documentation for advisers to provide to their clients to comply with the enhanced disclosure requirements. The current Ontario and Quebec requirements state that, upon request, advisers should provide to clients the names of research providers from whom research was acquired with soft dollars in the last fiscal year and a summary of those goods and services. The proposed instrument requires some general annual disclosure (similar to that

currently set out in OSC Policy 1.9 and AMF Policy Statement Q-20) in place, but adds the following components:

  - The total brokerage commissions paid during the period, for each class of security, and for each client's account or portfolio.
  - A reasonable estimate of the percentage of those commissions that represent order execution only, order execution bundled with proprietary services offered by the dealer, and order execution involving a portion of the commission payment being directed to a third-party.
  - For third party payments, a reasonable estimate of the proportion directed to research providers, directed to other third-party vendors, and retained by the dealer(s).

- This increased disclosure standard will likely result in up-front costs as advisers alter their current practices and procedures to track the necessary level of detail on an ongoing basis. The required information should be available to the advisor and the necessary changes would be limited to how that information is stored and manipulated. The ongoing cost of producing, printing, and mailing the disclosure will be mitigated if changes are made initially to how the information is collected.
- Dealers and advisers would have to review their current use of soft dollar commissions against the proposed instrument and its companion policy. The FSA estimates that in the U.K., a review would require six days of a compliance officer's time and one day of a lawyer's time.[10] We expect that a review would take a similar amount of time for Canadian dealers and advisers, resulting in an estimated one-time cost of about $3 million. Table 1 below shows the breakdown of this cost.

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

[10] OXERA, 2003, page 18. Although there are difference between the proposed instrument and the FSA's proposal we believe that this is a good estimate of the average effort required to review existing soft dollar arrangements.
[11] The estimates for compliance officer and management salaries are based upon discussions with human resources consultants familiar with the employment market for compliance officials.
[12] This is based upon estimates of salaries paid to experienced legal professionals in the regulatory community.
[13] We have assumed that all the 201 dealers and 805 adviser firms have soft dollar arrangements. We expect this to be a high-end estimate of industry costs as not all firm have soft dollar arrangements involving third-parties.

Estimated industry cost ($3,000 * 1,006 firms)	$2.8 million

- In Ontario and Quebec, most dealers and advisers are already monitoring compliance with the existing requirements. Dealers and advisers in other jurisdictions are likely to be familiar with the current guidelines and have some policies and procedures in place. The additional ongoing cost of monitoring compliance against the updated requirements would likely be quite small.
- Some contracts between dealers and advisers may need to be renegotiated to ensure compliance with the new requirements.
- As with the current Ontario policy, the specific elements in the guidelines would not be enforceable and therefore little guarantee that all advisers would follow the guidelines or that investors would receive higher quality disclosure. As a result, regulators could continue to see many of the same issues currently found during compliance reviews.
- There would continue to be inconsistent standards across the CSA and between mutual funds and other managed investments.

Benefits

- More certainty for market participants regarding acceptable practices.
- If disclosure guidelines were adopted, investors would have more information about their adviser's use of brokerage commissions to pay for non-execution goods and services. With more information, investors will be better able monitor their adviser's behaviour and ensure conflicts of interest are kept in check.
- Increased consistency with applicable UK and US regulations will help protect the competitiveness of Canada's capital markets. However, there is no guarantee that the standards would be adopted by all industry participants.

3. Complete ban

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

Costs

- One of the primary concerns about eliminating soft dollar commissions is the harm it may cause independent research providers. But how reliant are third-party research providers on soft dollars? The research by Greenwich Associates[14] found that over 60% of Canadian investment managers acquire third-party research via a soft dollar arrangement. As a comparison, only 27% use hard dollars to meet all or part of their independent research needs. Not only do a majority of advisers make such payments they are also of a potentially significant size. It is estimated that independent research represents 20% of all commission payments directed to third parties. As a result, prohibiting soft dollar arrangements could impact

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

research providers. However, since no comparable jurisdiction has banned soft dollar commissions, it is difficult to assess the extent of that impact.

- Greenwich Associates also found that purchasing independent research with soft dollars is also more common for smaller investment managers[15] and so prohibiting such payments could have a larger impact on that group. Increasing costs for new advisers could create a barrier to entry and may ultimately decrease competition between advisers and reduce choice for investors.
- Soft dollar commission arrangements are permitted in other jurisdictions, most notably in the U.S. and U.K. Therefore prohibiting the practice in Canada could result in a competitive disadvantage for Canada's securities industry. The lack of harmonisation with those other jurisdictions would make it difficult for Canadian dealers to attract business from international investment managers. Also foreign investment managers may be less willing to conduct business in Canada. This could also decrease the amount of money invested in Canada and therefore the liquidity of Canada's capital markets.
- There is no definitive proof for or against the existence of economies of scope in bundling trade execution with other goods and services. However if they do exist, unbundling will result in increased costs for advisers. This could make it more expensive for new advisory firms to enter the market and would eventually reduce competition and choice for investors. The reduced competition could, over time, lead to advisers charging higher management fees.
- There is the risk that dealers will still offer services to attract adviser business but by different means. For example, it has been suggested that banning soft dollar arrangements may result in increased principal trading by dealers. If the trade is executed by the dealer on a principal basis, the cost of that trade is built into the price and is therefore less transparent. Purchases of goods and services other than trade execution could then become less transparent for investors and regulators.
- Reflecting research costs as a management expense may motivate advisers to under-consume research and make sub-optimal decisions for their clients. Advisers may be reluctant to reduce their margins by using management fees to purchase the research. They may also be reluctant to increase those fees to pay for research, as advisers compete based upon the price they charge for their services.
- Some proprietary services offered by dealer may be difficult and/or costly to un-bundle.

Benefits

- If there are no economies of scope in the provision of bundled investment management goods and services, unbundling could result in lower costs for advisers and for investors.
- Greenwich's research indicates that 71% of Canadian investment managers would decrease their use of sell-side research if forced to pay for it with hard dollars[16]. This would indicate that advisers are over consuming dealer generated research

[15] Greenwich 2005 Statistical Supplement, pg 12
[16] Ibid

and so prohibiting soft dollar commission arrangements would benefit investors as they would only pay for trade execution and not other services that may not generate value.

- Similarly, the current environment may be distorting the market for independent research. Advisers may also be over consuming third-party research and therefore supporting research providers and products that do not generate value for clients.
- By requiring advisers to pay for non-execution goods and services from the management fee, advisors will have an incentive to ensure that all goods and services purchased are providing value. Of the investment managers Greenwich surveyed in 2005, over a quarter purchased independent research using hard dollars.[17] Clearly advisers see more value in independent research than in its sell-side equivalent. Prohibiting soft dollar commission arrangements may then lead advisers to substitute independent for sell-side research and as a result third party providers could see sales increase.
- Client brokerage commissions would only be used to pay for trade execution. This would likely eliminate the over-consumption of non-execution-related goods and services and would diminish incentives for advisers to make investment decisions that are not in their clients' best interest.
- Management fees would reflect the true cost of hiring an adviser's expertise and the full cost of their investment approach. Investors would find it easier to compare adviser services based upon price.

4. Reformulate requirements into a National Instrument

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

Costs

- Review of current soft dollar arrangements. The costs would be the same as those identified for Option 2, Update policy.
- Production and distribution of documentation for advisers to provide to their clients. The cost would also be the same as that identified under Option 2, Update Policy.
- The proposed instrument prohibits some services that were not clearly excluded previously. If these services did not generated sufficient value, the advisers will likely discontinue use as opposed to paying for them out of management fees. According to the Greenwich Associates research, the decreased demand is not likely to threaten the viability of the vendor's business.[18] Excluding these services from soft dollar arrangements may also encourage their vendors to offer products that do generate value for advisers.
- The increased level of disclosure will provide investors with more information about how their trading commissions are used. However, they may not have

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[17] Ibid, pg. 4

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

sufficient knowledge to determine if the purchased goods and services generated value and improved investment returns.

Benefits

- Although the potential for conflicts of interest will still exist, the proposed Instrument will decrease the opportunities for advisers to over-consume goods and services at the expense of their best execution obligations. The additional disclosure requirements will increase the adviser's accountability to their clients.
- Investors will be provided with sufficient information to be able to determine if the adviser is using brokerage commissions appropriately. The increased transparency will also allow investors to better compare advisers' services and so increase the competitive pressures on advisers.
- Since the instrument will have the full force of law, the threat of regulatory sanction will increase the incentives for advisers to regulate their own behaviour.
- Provides improved clarity for dealers and advisers about the goods and services that can be acquired with brokerage commissions. The Greenwich Associates research shows that advisers do use brokerage commissions to purchase services explicitly excluded in the proposed Instrument.[19] Investors will benefit from a reduction in the consumption of goods and services that do not sufficiently benefit them.
- The Canadian capital market will maintain its competitive position relative to the U.S. and U.K.
- Soft dollar arrangements can still be used to acquire independent research, helping to ensure that its providers are able to compete with dealer produced research.
- Ensures that the same standards are applied to advisers across the country. This will reduce confusion and uncertainty for investors, advisers and dealers.
- Provides incentives for advisers to be more aware of their fiduciary obligations and to provide goods and services in a cost-effective manner, or be subject to sanctions.

Conclusion

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

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

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[19] *Ibid.*

However, this option would not ensure consistently improved disclosure, harmonization, or enforceability and so does not meet all of our regulatory goals.

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