

APPENDIX A

Proposed National Instrument 23-102 Use of Client Brokerage Commissions as Payment for Order Execution Services or Research (“Soft Dollar” Arrangements) and Companion Policy 23-102CP

Summary of Comments and Responses

I. Response to Questions

Question 1: Should the application of the Proposed Instrument be restricted to transactions where there is an independent pricing mechanism (e.g., exchange-traded securities) or should it extend to principal trading in OTC markets? If it should be extended, how would the dollar amount for services in addition to order execution be calculated?

The majority of commenters were of the view that the Proposed Instrument should be restricted to transactions where there is an independent pricing mechanism (exchange-traded securities).

The reasons given were as follows:

- the fees associated with securities traded on a principal basis (such as fixed income securities) are imbedded in the price of these securities, cannot be easily measured, and the increased costs associated with the enhanced record-keeping needed to separate execution-only and research costs would not be justified given the lack of precision in the data;
- the lack of pre- and post-trade transparency in the OTC markets makes it difficult to separate the price of a security from the additional services provided;
- it is difficult or impossible to break out the commissions from the total transaction costs for securities traded on a principal basis;
- as long as commissions are not explicitly delineated by dealers, advisers will have to make their own estimates that will likely differ and lead to inconsistent disclosure;
- it is important to remain as consistent as possible with the FSA (whose requirements apply only to equities and related instruments) and the SEC (whose requirements apply to commissions on agency transactions and fees on certain riskless principal transactions that are reported under NASD trade reporting rules);
- it would be especially difficult to break down commissions for foreign fixed income securities because dealers in those countries are not be subject to the same requirements; and
- for securities traded on a principal basis there is limited scope for research and other services besides pure execution, so there is little value in “unbundling” the cost of execution in that case.

A few commenters, however, thought that transactions done on a principal basis should also be included in the scope of the Proposed Instrument, for the following reasons:

- soft dollar information should not be hidden from investors because of the type of product, transaction or market;
- there are proprietary broker-based fixed income research services paid for via the commissions implicit in bond spreads, and the calculation of the dollar amount is straightforward: that is, dealers place specific prices on each research service, and after

the execution of the trade has been agreed to, an extra amount is added and identified as a research service payment;

- if principal transactions are excluded from the Proposed Instrument, unscrupulous advisers with both fixed income and equity mandates may shift non-eligible expenses defined by the instrument from equity soft dollars towards soft dollars related to principal transactions; and
- it is unfair to closely monitor commission expenditures in public markets and not OTC markets; at the very least, participants in OTC markets should begin to disclose the amount and type of goods and services procured through the dealers.

However, there was acknowledgement of the difficulty in determining the dollar amount for bundled services received in conjunction with principal trades. Some commenters suggested that, if a decision is made to expand the applicability of the Proposed Instrument beyond transactions where there is an independent pricing mechanism, it should apply to any transaction where a transaction-based fee can be determined or reasonably estimated.

Response:

We agree that the lack of transparency regarding fees imbedded in the price of trades conducted on a principal basis in the OTC markets makes measurement of those fees difficult. The application of the Proposed Instrument is limited to certain trades in securities where brokerage commissions are charged. We have amended the guidance in the Proposed Policy to clarify that the reference to “client brokerage commissions” includes any 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).

The Proposed Policy also clarifies that advisers that receive goods and services other than order execution in conjunction with trades such as principal trades where a mark-up is charged (e.g., fixed income traded in the OTC markets), will remain subject to their general fiduciary obligations to deal fairly, honestly and in good faith with clients, but will not be able to rely on the Proposed Instrument to demonstrate compliance with those obligations. An adviser could likely apply many of the principles outlined in the Proposed Instrument and Proposed Policy in these situations to assess whether its general fiduciary obligations have been met, but this assessment may be more difficult and less supportable when information is not readily available to assist with a determination of value received for value paid (e.g., the security is not exchange-traded, or there is no other independent pricing mechanism to help identify the amount paid for the security versus the amount paid for execution plus any other services).

Question 2: What circumstances, if any, make it difficult for an adviser to determine that the amount of commissions paid is reasonable in relation to the value of goods and services received?

The majority of respondents thought that the main difficulty in assessing the reasonableness of the commissions paid relative to the value of goods and services received for transactions involving execution and research was the lack of information provided by dealers on the cost components of bundled services. Some noted that, unless dealers are required to unbundle

execution charges from charges for proprietary research, any attempt by advisers to determine the costs of execution and research, and whether they are reasonable in relation to the value of goods and services rendered, is merely an estimate.

One commenter, however, anticipates that the 2006 Instrument would cause “execution-only” trades to become more commonplace; in which case, industry norms would evolve as to what represents a competitive “execution-only” commission, and there will be far greater clarity as to the price being paid for goods and services relative to their value. Another commenter supported the view that “execution-only” trades may become more commonplace as total research costs come under more scrutiny, and limits are placed on the total spent for research.

Other reasons supporting the difficulty in assessing the reasonableness of value received for commissions paid included:

- while theoretical pure execution costs may be determined for a particular trade, the value of research is dependent upon the specific nature of the services provided and the circumstances under which it is provided;
- it would be difficult to determine reasonableness for an adviser that is small or just starting up, and/or if an adviser tends to execute transactions with only one dealer;
- there is a continuum of service levels ranging from low service direct market access to low to medium service algorithmic trading, to high-service execution involving liquidity search, monitoring and reporting the status of an order, feedback, execution advice and the provision of capital, all of which require different commission rates;
- in almost all cases, research received by an adviser is used for the benefit of more than one client, and a specific allocation of the benefits of research to one client would be nearly impossible;
- dealers often send advisers unsolicited research that is not used by the adviser; receipt of such research should not imply that the adviser is using commissions to pay for it; and
- advisers consider the reasonableness of commissions paid to dealers over time, and in context of the overall business relationship, not on the basis of individual trades.

In conjunction with the comments regarding the difficulties in determining whether commissions paid are reasonable in relation to the goods and services received, some commenters suggested that an approach consistent with that of the SEC, as described in their July 2006 Release should be taken: i.e. advisers should be required to make a good faith determination that commissions paid are reasonable in relation to the value of the research or brokerage services received, either in terms of the particular transaction or the manager’s overall responsibilities for discretionary accounts.

Three commenters suggested that use of a robust independent commission management system would help monetize the value of bundled research or execution services paid for with commissions. They noted that new software solutions for evaluating soft dollar arrangements would help buy-side firms quantify the services received from dealers without additional administrative burden.

Response:

We understand the concerns relating to the difficulties in determining if commissions are reasonable in relation to the order execution services and research services received, particularly in relation to bundled services. We still think it is important for an adviser to make

a determination of whether the value of the goods and services received is reasonable in relation to clients' commissions paid to help ensure that clients are receiving adequate value.

We have made changes to the Proposed Instrument to require the determination to be made in good faith, and to the Proposed Policy to clarify that such a determination could be made in terms of either a particular transaction or the adviser's overall responsibilities for client accounts.

Question 3: What are the current uses of order management systems? Do they offer functions that could be considered to be order execution services? If so, please describe these functions and explain why they should, or should not, be considered "order execution services"?

Some respondents indicated that order management systems (OMSs) and order execution/execution management systems have become so intertwined that it is difficult to separate the order management system from the execution process.

Various respondents provided examples of the current uses of order management and order execution / execution management systems. In general, commenters indicated that these systems track the progress of an order from its initiation to completion. More specific examples included:

- modeling trades / execution strategies and portfolios;
- order entry, routing and messaging;
- collection of orders for multiple point entry;
- bulking of smaller orders;
- order and trade allocation;
- direct contact from the advisers to the trading desk;
- algorithmic trading functions and direct market access;
- analytic tools to assist in the investment decision-making process, including pre- and post-trade analytics;
- facilitating the expediency of the execution process;
- analyzing portfolio strategies;
- evaluating execution quality;
- post-trade matching;
- routing of settlement instructions;
- report generation;
- security-master information;
- compliance;
- portfolio administration; and
- record keeping.

The majority of commenters generally agreed that OMSs contain portions that are used to assist in the order execution process that should be considered order execution services, such as:

- modeling trades and execution strategies;
- order routing and messaging;
- direct market access and algorithmic trading functions; and

- settlement functions such as post-trade matching, and the routing of settlement instructions to custodian banks and clearing agents.

Others added that portions of OMSs could be considered research to the extent they assist in the investment decision making process. Examples included:

- market data integration tools;
- analytic tools; and
- portfolio and strategic modeling tools.

One commenter suggested that features such as managing trade allocations, monitoring portfolio risk, or certain compliance features should qualify for soft dollar reimbursement, but should be judged on their individual characteristics as to whether they are execution or research oriented.

Many of the commenters also indicated that there are portions of OMSs that are used for administrative purposes which should not be eligible, such as compliance, accounting and recordkeeping functions.

A few commenters were of the view that OMSs should not qualify as order execution services. The reasons were:

- since the main trading function of an OMS is routing orders to venues, platforms and sell-side participants which provide order execution, the functionality that improves the quality of order execution typically resides outside of the OMS and the primary benefits of OMSs accrue to the investment manager and not the asset owners;
- tools of the trade such as the basic hardware, software, reports, communication links and other resources needed to competitively and compliantly run a contemporary mutual fund should not be considered order execution services and the costs should be paid for through the management fee;
- order management services provide a strategic advantage to firms that use them, and should therefore not be paid using client brokerage commissions.

Response:

We agree with commenters that order and execution management systems can include functions that could be considered either order execution services or research services. For example, to the extent that they provide analytic and modeling tools used in the research process, or are used to assist in arranging or effecting a securities transaction, these portions may be eligible providing the adviser meets its obligations under Part 3 of the Proposed Instrument.

We also think that it would be difficult to argue that the portions of these systems used for administrative functions such as compliance, accounting and recordkeeping would sufficiently benefit the client by providing appropriate assistance in making investment decisions, or in effecting securities transactions, to justify their payment with client brokerage commissions. As a result, we think these systems would generally be considered mixed-use in nature.

Question 4: Should post-trade analytics be considered order execution services? If so, why?

The majority of commenters thought post-trade analytics should be considered order execution services for the following reasons:

- assessment of past trading is a key part of the process of achieving best execution;
- they aid an adviser in making future decisions about how trades should be allocated among the brokers who provide execution services and the method of execution that is most appropriate (e.g. trader-managed; agency/principal blocks; algorithms; direct market access, etc.);
- they can influence how, when and where an adviser decides to trade;
- post-trade analytics are a key part of how an adviser reviews the order execution process and improves it – through analysis of past trades to uncover problems in, or validate, a trading strategy, execution method or venue, dealer capabilities, etc; and
- they are all part of a continuous process, and a key part of analyzing the indirect or slippage costs within the trading process.

A number of respondents believed that post-trade analytics should be considered research. The reasons were:

- they are received and considered by the adviser before making further trading decisions, even if they are received after certain trades have been concluded;
- they include information about how well a broker conducted a particular transaction or series of transactions for an investment manager, as well as advice on liquidity and market-related timing, negotiation of the terms of a trade and other aspects of order handling;
- they assist advisers in assessing trading effectiveness;
- they assist in achieving best execution for clients; and
- they feed into an adviser's trading decisions and help promote competition between execution platforms.

One commenter noted that post-trade analytics are more properly characterized as research than order execution services, and that even though post-trade analytics are received after certain trades have been concluded, they should be considered research to the extent they help determine a subsequent investment or trading decision.

A number of commenters noted that post-trade analytics should be mixed-use products because they contain components that do not assist in making subsequent decisions, and are not received during either of the temporal standards contemplated for research or order execution services. For example, some of these commenters noted that post-trade analytics should not be eligible for payment with client commissions when used to evaluate portfolio performance for marketing purposes, recordkeeping, administrative and compliance purposes.

Response:

Many of the reasons given by commenters for why post-trade analytics might be considered order execution services are the same as those given in support of their eligibility as research services. This appears to be a result of differing interpretations of the temporal standard for order execution services. We have made amendments to the definition of research services in the Proposed Instrument and to the guidance in the Proposed Policy that should serve to clarify that

the temporal standard for order execution services starts after the adviser has made its investment decision (i.e., the decision to buy or sell a security). The amendments made would therefore allow for consideration of post-trade analytics as order execution services to the extent they are used to determine a subsequent decision of how, when or where to place an order or effect a trade. These amendments relating to the temporal standard are discussed in more detail later in Section II of this response to comments.

As suggested by the guidance provided in the Proposed Policy, we also think that to the extent that post-trade analytics are used for administrative or compliance purpose, it would be difficult for an adviser to argue that these uses provide appropriate assistance, and to therefore justify paying for these portions with client brokerage commissions. As a result, we think post-trade analytics would generally be considered mixed-use in nature.

Question 5: What difficulties, if any, would Canadian market participants face in the event of differential treatment of goods and services such as market data in Canada versus the U.S. or the U.K.?

The overwhelming majority of commenters thought that the Canadian approach should be harmonized with the U.S. and U.K. approaches. The following reasons were given:

- adopting conflicting regulatory requirements would put Canada at a severe competitive disadvantage and encourage regulatory arbitrage;
- while a foreign adviser will be able to use commissions to pay for certain services, the Canadian adviser will have to absorb those costs as fixed-costs or by charging an increased fee; this may result in loss of business for Canadian advisers and any long term-decline in profitability will encourage Canadian advisers to move to other jurisdictions where the regulatory regime does not impair their ability to compete;
- if raw data feeds are excluded for Canadian advisers and not U.S. advisers, quantitative money managers in Canada would suffer a disadvantage compared to their U.S. counterparts because their data would cost more; they will have to charge higher investment management fees to international and U.S. clients than their U.S. peers, which will result in the loss of non-Canadian clients;
- if an inconsistent approach is taken, firms with offices in multiple jurisdictions would have to choose between adopting the strictest standards for all offices or suffering the inconvenience and costs of having different processes applicable to different clients' commission dollars, depending on the jurisdiction;
- differential treatment will result in additional costs for advisers in Canada who use sub-advisers in the U.S. or the U.K., as the sub-advisers will be forced to pay for the development of systems required to track the information required by Canadian regulators; and
- as Canadian mutual funds increase their holdings in foreign securities, now that the foreign content restrictions on RRSPs have been lifted, they increase their reliance on non-Canadian sub-advisers; inconsistent rules would make it difficult or nearly impossible for foreign firms to comply with Canadian rules, and foreign advisers may decide that dealing with Canadian advisers is more trouble than it is worth, effectively reducing Canadian access to necessary international expertise when it is needed most.

A number of commenters acknowledged that differences exist between the U.S. and the U.K. regulation, and noted that it is more important to harmonize the Canadian requirements regarding soft dollars with the U.S., for the following reasons:

- Canadian market participants are more familiar with U.S. standards;
- the SEC approach of focusing on how a given good or service is being used by the adviser is a preferable basis for determining eligibility for payment with soft dollars, rather than the detailed and complex categorization underlying U.K. rules;
- U.S. advisers are Canadian advisers' true competition for institutional investment management;
- U.S. domiciled advisers that work on behalf of Canadian funds and institutional clients would have a significant advantage under the Proposed Instrument as they would be able to pay for additional items (e.g. raw data feeds) with commission dollars (Canadian advisers would have to pay for these services from their operating budget, leading to lower management fees for U.S. advisers and a flight of capital away from Canadian advisers); and
- Canadian market participants that engage in cross-border business will likely try to ensure that their practices comply with SEC requirements.

Response:

We think that those commenters that suggested we harmonize our requirements with the requirements and guidance of both the U.S. and U.K. may have overlooked the differences between the requirements and guidance items in these two jurisdictions which precludes harmonizing with both. These differences were highlighted in our notice that accompanied the 2006 Instrument.

We agree that harmonization with other jurisdictions is appropriate to the extent it is justifiable in our view to do so and are aware of the importance of harmonizing with the requirements and guidance in the U.S. We have taken all the comments into consideration and have made amendments to the Proposed Instrument to harmonize requirements with those in the U.S. to the extent it is justifiable to do so.

Question 6: Should raw market data be considered research under the Proposed Instrument? If so, what characteristics and uses of raw market data would support this conclusion?

The majority of the commenters were of the opinion that raw market data should be considered research. Reasons given included that:

- raw market data is used to evaluate research generated by others;
- raw market data is a valuable input to advisers that perform their own research, whether on a general basis, or if used in quantitative models and for back-testing of those models;
- quantitative managers and advisers that perform their own research would be put at a competitive disadvantage if they cannot pay for raw market data to use as an input for their own research, compared to advisers that use commission dollars to purchase others' research based on the same market data; and

- allowing raw market data to be considered research would be consistent with the position taken by the SEC, and would ensure a level playing field between U.S. and Canadian managers.

In addition, some commenters stated that the proposed definition and guidance regarding research are inadequate as research does not need to contain original thought, and that data does not need to be analyzed or manipulated to express an opinion, as data can be used by advisers in forming their own opinions and therefore add value to the investment decision making process.

A couple of commenters suggested that although raw market data does not, in and of itself, add value to an investment or trading decision, if it is used as an input to analytics, or with tools for research purposes, it should be considered research. One of these commenters stated that it is incongruous to allow quantitative analytical software as research, but to not allow raw market data which is an input to that software, and added that reasoning should not be separated from the supporting data on which it was based.

Some commenters also argued that raw data has great value, otherwise Bloomberg, Reuters and their competitors would not spend a great deal of money collecting it and selling it to arms-length parties if advisers could do so themselves at a lower cost. Two other commenters added that efforts expended in sorting, ordering and presenting the data in a usable format manifests the thought, knowledge and expression of reasoning necessary to elevate raw data to the status of research. One commenter suggested that while simple quotes and volume information should not be allowed because they are cheap and readily available, some market data that is more difficult and expensive to obtain such as historical depth of market data used in the development of trading algorithms should be classified as research.

Some commenters raised a concern that if raw market data were not permitted as research, advisers would be encouraged to purchase raw data that has been slightly manipulated in order to be able to continue to pay for the underlying raw data with commission dollars. A couple of these commenters noted that the interjection of an intermediary in these circumstances would also likely result in higher costs for the raw data.

However, there were some commenters that did not believe that raw market data should be considered research if it is not analyzed or manipulated. A couple of commenters also indicated that that there is generally no value added from raw market data but that, if the data is used to support modeling applications that provide analyses used to support investment decisions, it should be permitted as there is a clear benefit.

Most of the commenters also agreed that raw market data should fall within the definition of order execution services to the extent it assists in the execution of orders.

Response:

We agree that there are situations where raw market data is used by advisers as an input to their own research efforts, and that such uses could add value to the investment decision-making process. We also agree that to view raw market data as not eligible as research services could put these advisers at a competitive disadvantage relative to those advisers that use commissions to pay for others' research based on the same market data. As a result, we have amended the examples of eligible research services in the Proposed

Policy to include market data from feeds or databases that has been or will be analyzed or manipulated by the adviser to arrive at meaningful conclusions – this would include raw market data.

In making this amendment to the Proposed Policy, we also recognize that the definition of research services, and the guidance provided in relation to the characteristics of such services, would not accommodate the inclusion of raw market data and other potentially valuable inputs to the research process. We acknowledge that goods and services do not necessarily need to contain original thought, or need to be analyzed or manipulated prior to receipt, in order to be used for the benefit of clients by assisting in the investment decision-making process. We have made amendments to the definition of research services in the Proposed Instrument, as well as to the guidance on research services provided under section 3.3 of the Proposed Policy to reflect these views.

We have not changed our previous position that raw market data may also be eligible as order execution services.

Question 7: Do advisers currently use client brokerage commissions to pay for proxy-voting services? If so, what characteristics or functions of proxy-voting services could be considered research? Is further guidance needed in this area?

Four commenters indicated that they use, or are aware of the use of, client commissions to pay for proxy services, while five indicated that they do not use, or are unaware of the use of, client commissions to pay for proxy services.

Most of the commenters that addressed this question believed that proxy services could be considered research to the extent used to support investment decision-making. Examples of the characteristics and uses of proxy services that support this position included:

- proxy voting services assist advisers in assessing the impact of mergers and acquisitions, proxy contests, takeovers, and other proxy proposals on shareholder value;
- they provide analysis of matters to be voted on, along with a recommendation on how to vote proxies;
- they provide research on an investee company's standards of corporate governance or research that assists in monitoring trends in corporate governance; and
- they assess the quality of the issuer's management team or provide analyses, reports or information about the issuer.

Some of these commenters also added that although proxy services should be considered research, there are functions provided by these services that may not be considered research, such as the administrative functions of receiving, voting and returning ballots. These commenters therefore viewed proxy services as mixed-use.

Three of the commenters did not believe that proxy services should be considered research at all. Arguments included that:

- proxy services have administrative and non-research uses that should not be paid for with client brokerage commissions;
- there is no value-added component for proxy services; and

- inclusion of proxy services as research could stimulate undue, costly trading.

One of the commenters suggested that further guidance should be provided on whether components of proxy services that are used to decide how to vote proxy ballots are analogous to traditional “maintenance research” and eligible for payment with client commissions. Two commenters did not feel any additional guidance was necessary.

Response:

We agree that proxy services include products and services that could be considered research services; for example, if they provide information on corporate events such as mergers and acquisitions or constitute an analysis on corporate governance. We also agree that proxy services include functions that would not be considered research services, such as the administrative functions of receiving, voting and returning ballots.

Advisers that have determined that certain proxy services meet the definition of research services should also ensure that the services are used to benefit clients by providing appropriate assistance in making investment decisions for clients. For example, it may be difficult to support the claim that using research services provided by proxy service providers to assist with the administrative function of voting proxies (including if used to assist with decisions on how to vote proxy ballots) on behalf of clients provides appropriate assistance in making investment decisions.

As a result, we think proxy services could be viewed as mixed-use goods and services depending on both content and use. We do not believe any additional guidance is necessary at this time.

Question 8: To what extent do advisers currently use client brokerage commissions as partial payment for mixed-use goods and services? When mixed-use goods and services are received, what circumstances, if any, make it difficult for an adviser to make reasonable allocations between the portion of mixed-use goods and services that are permissible and non-permissible (for example, for post-trade analytics, order management systems, or proxy voting services)?

Eight of the commenters, accounting for approximately half of the respondents, indicated that they use, or are aware of the use by their constituents of client brokerage commissions as partial payment for mixed-use goods and services. Some of the more common types of such goods and services included:

- data services such as Bloomberg and Reuters;
- proxy services;
- order management services; and
- trade analytics.

Two commenters indicated they did not use client brokerage commissions to pay for mixed-used services. One of these indicated that costs for any mixed-use items are treated as corporate operating expenses which are paid for with “hard” dollars. The reasons given were that the allocations would require extensive documentation and could be subject to differences in opinion on the appropriateness of the allocation.

Two commenters indicated that they use, or would use, client brokerage commissions as partial payment for mixed-use goods and services only if they could achieve an objective allocation of costs, for example, if a service had separate identifiable components to which separate prices were attached. One suggested that the criteria for determining whether a mixed-use item may or may not be paid for in part with client commissions should be simple and flexible enough to allow the adviser to make a reasonable determination as to whether a given item is being used to make investment decisions.

Circumstances that can make it difficult for an adviser to make reasonable allocations between the portion of mixed-use goods and services that are permissible and non-permissible included:

- when such goods and services are received as part of a bundled services offering without any cost information from the dealers or any reliable mechanism for separating the component parts, it would be difficult and costly to estimate the value received;
- without prescriptive rules on what is permissible and non-permissible, it would be difficult to make allocations because of the subjectivity involved; and
- there is potential for divergence among dealers in the industry regarding eligible items.

Some commenters suggested approaches to deal with the difficulties in making a reasonable allocation between the permissible and non-permissible portion of mixed-use goods. For example, advisers:

- could make a good faith determination, and keep adequate books and records regarding the allocations;
- could make allocations as judiciously as possible and include their underlying rationale as part of their disclosure to clients; and
- should seek assistance from mixed-use service providers in order to break down the service into component parts that qualify or do not qualify, and obtain a separate costing for each of these components.

One respondent, however, thought that the allocation process is becoming easier as vendors are providing more guidance regarding the research, brokerage and administrative components of their products and services.

Response:

We continue to think that a mixed-use approach is appropriate. We acknowledge that making allocations can be difficult, particularly in relation to goods or services obtained in exchange for bundled commissions. However, client brokerage commissions should not be used to pay for goods and services an adviser obtains that do not meet the definition of order execution services or research services, or that are not used by the adviser to assist in the investment decision-making process or with the arranging and effecting of securities transactions.

Therefore, we think that if an adviser obtains mixed-use services with client brokerage commissions, it should make a reasonable allocation of those brokerage commissions paid according to the use of the goods and services. We have provided additional guidance in the Proposed Policy that 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 utility derived from, or the duration the good or service is used for, eligible and ineligible uses.

We also continue to think that advisers should maintain adequate books and records concerning the allocations made in relation to mixed-use items in order to be able to demonstrate their good faith determination of the reasonableness of value received for commissions paid, and to demonstrate that clients have not paid for goods and services from which they do not receive benefit.

While we support efforts being undertaken by vendors to delineate the costs associated with various eligible and ineligible components, the additional guidance provided in the Proposed Policy suggests that an adviser should also be considering its use of the eligible components to assess the extent of its reliance on the vendor-provided cost allocations. For example, an adviser would have difficulty justifying its reliance solely on a vendor's cost allocations to determine the amount that could be paid for with client brokerage commissions if the adviser were to use that portion classified by the vendor as meeting the definition of order execution services or research services for purposes other than making investment decisions or arranging and effecting securities transactions (e.g., if used for administrative or compliance purposes).

Question 9: Should mass-marketed or publicly-available information or publications be considered research? If so, what is the rationale?

The respondents' views were mixed regarding the treatment of mass-marketed or publicly-available information. Specifically, 11 commenters believed that the CSA should follow the SEC's approach and focus on the target of the mass-marketed or publicly available information. That is, information and publications such as newspapers, magazines, or online news that are aimed at a broad audience should not be considered research, but certain information and publications that cater to a narrower audience, such as trade magazines, technical journals, or industry-specific publications may add value to the adviser's investment or trading decisions and should therefore be permitted. Reasons given were:

- mass-marketed information does not have a value-added component that would qualify it as research, but certain publications that are trade, industry, sector or investment specific may be used for further investment decisions;
- mass-marketed information such as newspapers, magazines, periodicals, and online news should not be considered research as they relate to a routine expense for which hard dollars should be paid;
- certain newsletters and trade journals, although publicly available, serve the interests of a narrow audience and can provide an important foundation for unique and independent research; and
- trade magazines, technical journals or industry-specific publications are particularly relevant for managers and traders when conducting research.

One of these commenters suggested, however, that mass-marketed publications in foreign countries should be allowed, as they are not immediately available to Canadian advisers. This would avoid advisers having to rely on foreign brokers to relay this information to them.

Seven commenters indicated that mass-marketed or publicly-available information or publications should not be considered research. Reasons included:

- mass-marketed or publicly available information does not contain sufficiently sophisticated analysis to add value to investment or trading decisions; and

- while there may be some specialized publications that could qualify as research, the CSA should be concerned if some specialized publications that should be considered part of an advisor’s continuing education or professional development are included in this category.

Six commenters thought that any publicly available information or publications, whether they are mass-marketed or not, should be considered research. The reasons were as follows:

- mass-marketed or publicly available information may provide valuable information to those knowledgeable enough to draw conclusions from them – for example mass-marketed material from a European source (possibly in another language) is often not generally known, especially among English-speaking North American analysts;
- the fact that some information is mass-marketed and/or has a lower cost is reflective of the efficiency of the market, not whether it has value to an adviser and, therefore, if an adviser can obtain market and corporate information from such publications versus paying more to a dealer via commissions to obtain the same information, it is better for the client;
- publications like Barron’s and the Wall Street Journal can, and do, include exhaustive analysis and research relevant to the investment decision-making process, and also provide information that can move markets; and
- if permissibility is only based on how widely available information is made, then it may run up against issues concerning “insider” information.

Two commenters thought that additional clarification is needed regarding the phrase “publicly available” information given that all publications that are considered to be research are “publicly available”.

Response:

We agree with commenters that suggest that publications marketed towards a narrow audience, such as trade magazines, technical journals, or industry-specific publications could provide valuable assistance in making investment decisions and could therefore be paid for with client brokerage commissions.

We continue to think that mass-marketed publications, which are those that are marketed towards a broad, public audience, and are typically of low cost, are more like overhead of an adviser’s business and should generally be paid for with an adviser’s own funds. Further, we believe many of these types of publications often contain a wide range of information, much of which would either typically not be sufficiently related to the subject matter of the definition of research services (i.e., not related to securities, portfolio strategy, issuers, industries, etc.), or would not provide appropriate assistance in making investment decisions. For these reasons, we believe it would be difficult for an adviser to justify paying for mass-marketed publications with client brokerage commissions.

We have amended the guidance provided in the Proposed Policy to reflect these views. We have also removed reference to the term “publicly available” in relation to these types of goods and services. Even if a publication that is marketed to a narrow audience with specialized interests is publicly available to a broad audience, its availability does not make it ineligible to be paid for with client brokerage commissions.

Question 10: Should other goods and services be included in the definitions of order execution services and research? Should any of those currently included be excluded?

Two commenters did not believe any other goods and services, other than those discussed in the 2006 Instrument and 2006 Policy, should be included.

Other commenters provided examples of other goods and services for which guidance could be provided, as described below.

Seminars

Various commenters believed that seminars should be eligible for payment using client brokerage commissions. Reasons included that:

- seminars are simply an alternative medium by which to communicate information which may otherwise constitute research;
- seminars provide advisers with opportunities to refine their investment decision making process and to generate new analytical methods or investment ideas;
- blanket removal of seminars would hurt small advisers, especially those specializing in exotic areas or high tech areas where the fast pace of change requires constant innovation and learning;
- it is often cheaper for an adviser to pay for one conference and obtain access to multiple analysts than to pay commissions to each of their firms for access;
- some industry leaders only address the adviser community through these events; and
- allowances exist under NI 81-105 for mutual funds to provide seminars and conferences to dealers at no charge, or for mutual funds to pay for these on behalf of dealers, subject to certain conditions relating to the payment for the costs of travel, accommodation and personal incidental expenses.

It was suggested by one commenter that investor conferences sponsored by dealers should be eligible for soft dollar expenses so long as these expenses are reasonable in nature: for example, a trip to New York or Atlanta for a North American media conference is reasonable, while a trip to Aruba for a North American mining conference is probably not reasonable. This commenter also suggested that a compromise solution may be to allow only conference fees to be paid for with commissions.

Another commenter suggested that seminars with more social content than research could be disqualified.

Response:

We agree with commenters that seminars are one method to convey information that may otherwise constitute research services. On this basis, we have amended the Proposed Policy to reflect the view that seminars and conference fees that, in the adviser's judgement, will benefit clients and otherwise meet the requirements of the Proposed Instrument may be paid for with client brokerage commissions. The amendments to the Proposed Policy also would suggest that it would be difficult for an adviser to argue that incidental costs incurred in attending seminars or conferences, such as travel, accommodation or entertainment, could be eligible.

Telephone / Data communication lines

Four commenters supported including dedicated communication lines as an eligible order execution service for the following reasons:

- although the provision of such lines may be solely incidental and not a consideration in an adviser's order routing system decision, the lines nevertheless may be deemed to satisfy the temporal standard for order execution services;
- the lines assist advisers with the timely and accurate entry, handling or facilitation of an order by a dealer and are therefore directly related to order execution;
- banning connectivity hardware used to facilitate electronic trading and direct market access is unfair because it favours dealers and discriminates against advisers – dealers will charge the adviser for direct market access through commissions expense, but if an advisor were to choose to build a direct connection to the exchange to achieve direct market access and bypass the dealer (a very common occurrence in the U.S.), the hardware costs associated with achieving full connectivity would be precluded from order execution services; and
- such services are permitted by the SEC.

Two commenters argued that if the decision as to what goods and services can be purchased with commissions were based on their use, then eligible goods and services should also include hardware and communication lines as long as the adviser can demonstrate dedicated usage in the order execution or research processes.

One commenter was of the view that the CSA should specifically prohibit any data/voice/video communication lines (whether open or dedicated), internet fees, satellite links, and the like.

Response:

While we agree that the timeframe for using connectivity hardware/lines would fall within the temporal standard for order execution services, and acknowledge that such services are permitted by the SEC, we do not believe these are sufficient reasons to treat these any differently from other overhead type costs, such as those associated with computer hardware which might be used during the same timeframe. As a result, we believe it would be difficult for an adviser to justify paying for these goods with client brokerage commissions.

We have not provided any additional guidance on this matter in the Proposed Policy, as we believe the guidance provided under section 3.5 with respect to "Non-Permitted Goods and Services" is sufficient.

Opinions

One commenter indicated that the payment of costs for expert opinions used in the research process should be considered a research expenditure.

Another commenter stated that commissions may include other services paid for by the dealer, such as costs incurred by the dealer for providing legal advice to defend the value of an investment.

Another commenter indicated that legal advice relating to the likelihood of a company winning a patent fight should be considered eligible as research.

Response:

We agree that there may be circumstances where an adviser may seek expert opinion (for example, accounting or legal advice) in the course of assessing the value of an investment for purposes of making an investment or trading decision. We believe that such services may be eligible for payment with client brokerage commissions to the extent they meet the definition of research services and assist in making investment decisions.

We have amended the guidance provided in the Proposed Policy under section 3.5 to clarify that the legal and accounting services that would be considered non-permitted are those that relate to the management of an adviser's own business or operations.

Pre-trade analytics

Three commenters suggested that pre-trade, along with post-trade, analytics should be considered order execution services. One of these indicated that pre-trade analytics are directly linked to the execution of specific orders and are integral to the measurement of quality of execution and the achievement of best execution.

Response:

Taking into consideration the amendments made to Proposed Instrument and Proposed Policy regarding the temporal standard (discussed in more detail in Section II of this response to comments), we agree that to the extent that pre-trade analytics are used to help determine how, where and when to place an order or effect a trade, they could be eligible as order execution services.

We do not believe any additional guidance is necessary.

Databases and software

One commenter noted that the definition of research does not include “databases and software”, which are currently included in the definition of “investment decision-making services” under existing OSC Policy 1.9 and AMF Policy Statement Q-20, to the extent the databases and other software are designed mainly to support the advice and analyses expressly included in that definition. This commenter believes that the proposed definition should be expanded to expressly include such goods and services for consistency with the guidance provided in the Proposed Policy which allows quantitative analytical software to be considered research.

Response:

We agree and have amended the definition of “research services” in the Proposed Instrument accordingly. The definition now includes databases and software to the extent they are designed mainly to support the services referred to in subsections (a) and (b) of the definition. Additional guidance has also been provided under section 3.3 of the Proposed Policy.

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Question 11: Should the form of disclosure be prescribed? If prescribed, which form would be most appropriate?

Eight commenters indicated that the form of disclosure should be prescribed. Four others suggested that instead of prescribing the form of disclosure, more guidance, or a suggested format, should be provided and advisers should be allowed the discretion to develop their own forms. Reasons supporting why prescribing or providing more guidance on form of disclosure would be beneficial included ensuring that:

- disclosure is consistent and comparable between advisers;
- disclosure is understandable to clients; and
- focus is placed by solution providers on developing products that satisfy the needs of both dealers and advisers.

Commenters generally did not make suggestions regarding the form of disclosure, although two commenters suggested that advisers should be allowed to integrate the disclosure into existing client reports to help reduce costs to registrations and to reduce confusion by clients, for example, by integrating any new disclosure into the disclosure currently required under NI 81-106 for mutual funds. Another commenter suggested that the format for disclosure should appear on a single page and be enclosed with quarterly client statements, to allow for timely delivery in an investor-friendly format.

Response:

As a result of the amendments made to the disclosure requirements of the Proposed Instrument, we do not believe that the form of disclosure needs to be prescribed at this time. Should the quantitative disclosure requirements be expanded in the future, we will reconsider whether a suggested template should be provided as guidance.

Question 12: Are the proposed disclosure requirements adequate and do they help ensure that meaningful information is provided to an adviser's clients? Is there any other additional disclosure that may be useful for clients?

A. General comments

Most commenters did not believe the proposed disclosure would provide clients with meaningful information, and some believe that the disclosure could be misleading or confusing to clients. Many of these commenters, however, agreed that disclosure is important to demonstrate and ensure that adviser and investor interests are aligned. The majority of the concerns related to the proposed quantitative disclosure requirements under paragraphs 4.1(1)(b) through (d) of the 2006 Instrument. General reasons provided in support of these views included that:

- the proposed disclosure would be inconsistent with that currently required by the FSA and SEC;
- the level of detail disclosed will be too complicated for most clients to understand;
- a lack of understanding of how various factors affect the level and usage of client brokerage commissions may lead clients to misinterpret the results;

- reasonable estimates and allocations at the client level would be subjective, and inconsistencies between methods used by advisers would result;
- investors focus on total costs of the trades, total returns relative to risk, how the commission amounts were arrived at, and what the adviser took into consideration when agreeing to pay such amounts;
- it is not appropriate to compare commissions without considering market impact costs which, in many cases, are the most significant part of a trade's total cost;
- comparison of client specific information may be meaningless when compared to a blended average across all mandates, particularly for those advisers with global mandates;
- distinguishing between "execution only" and "bundled commission" rates would mislead investors to conclude that the difference in commission rate is a result of obtaining research, and ignores the argument that full-service bundled execution is often the best trading method to achieve best execution, and not merely a method to pay for research;
- pure order execution without any other services is not as common a practice anymore as advisers generally trade with dealers that can add value by offering other services;
- disclosure on an aggregate or weighted average basis does not take into consideration the varying nature of portfolios, portfolio managers, soft dollar arrangements and commission recapture agreements;
- disclosure by asset class may not be useful given that there may be multiple investment strategies employed within a single class of securities and trading can vary depending on market conditions, interest rate movements, portfolio rebalancing, etc., which may result in inconsistencies from one period to the next;
- fluctuations in trading activity from year to year can result in inconsistencies in disclosure when spread over soft dollar commission budgets, which do not fluctuate from year to year, and do not contemplate proprietary goods and services;
- commissions may be negotiated and may change due to a variety of circumstances depending on the nature of the transaction and the liquidity profile of a security;
- the question of value received for the percentage of commission allocated to any one dealer is not addressed by the disclosure; and
- clients are already inundated with disclosure.

Two commenters indicated that the proposed disclosure requirements would provide meaningful information to clients.

B. Suggestions regarding appropriate disclosure

(a) Narrative disclosure

Commenters were generally not opposed to either the proposed narrative disclosure, or to some other form of narrative disclosure. Suggestions for narrative descriptive disclosure made by commenters included:

- details on an adviser's policies and procedures regarding client brokerage commissions, which could include:
 - the adviser's soft dollar policy;
 - a description of the adviser's best execution policy;

- the factors advisers consider when selecting dealers and trading venues, including whether research is a factor;
- the policy for how research is purchased;
- following the narrative format required by the SEC in Form ADV Part II, or the IMA's Level I disclosure;
- the general types of services dealers provided to the adviser;
- the nature of the arrangements;
- the names of dealers used, and the names of third parties that provide goods and services;
- a statement that all soft dollar arrangements are solely for the benefit of clients;
- a statement that trades are done on competitive terms;
- a statement that an internal process which ensures that fair value is being paid to dealers in return for services being purchased is utilized along with disclosure of situations where the adviser is aware of a material discrepancy between the value obtained and commissions allocated to a dealer over a certain time period – this would ensure that advisers are actively interpreting the data they are being required to gather and disclose, and ensure demonstration that soft dollars are being used appropriately; and
- for investment funds, including a statement in a prospectus that a fund engages in soft dollar trading, and that one of the defined risks is a conflict of interest between the manager and the fund.

(b) *Quantitative disclosure*

Although many commenters had concerns with the proposed quantitative disclosure, there were various suggestions made regarding what quantitative disclosure could be meaningful to clients. Various commenters also seemed to agree that, should quantitative disclosure be required, it should be accompanied by some form of narrative disclosure to add the appropriate context. The commenters' suggestions are set out below.

i) Firm-level disclosure

Some commenters stated that disclosure of commissions at the firm level was more appropriate than disclosure at the client level because clients select an adviser based on how the business is run overall, and whether the adviser will manage the money effectively.

Some commenters provided examples of firm level disclosure that could be appropriate, including:

- aggregate commissions;
- total commissions used for order execution services and research;
- commission rates paid to all brokers;
- commission rates paid to obtain order execution services and research;
- a ratio similar to a Management Expense Ratio, such as a ratio of the total costs of client commissions to assets under management;

Another commenter suggested that instead of aggregating at the firm level, commissions should be aggregated at the investment strategy level in order to provide more meaningful comparisons to client specific disclosure, although this commenter questioned the usefulness of comparisons

by investment strategy. Another commenter requested clarification regarding the level of aggregation among different types of accounts (i.e., mutual funds, sub-advised accounts, private managed accounts).

ii) Client-level disclosure

Some commenters also made suggestions for disclosure that could be provided at the client level that would provide meaningful information to clients. One commenter suggested that client-level disclosure should be limited to disclosure only of the commissions paid by the client's account or portfolio to avoid issues relating to comparability between client and firm figures, particularly when the firm has a variety of differing mandates.

One commenter believed that any quantitative client-level disclosure should be based on a pro-rata estimate based on the average assets under management of the client and firm, because of the difficulties for advisers to itemize which specific services were used for an individual client account.

Another commenter suggested the percentage of client commissions allocated to soft dollars in each of the client's account(s) could be provided, along with the total value of commissions used at a firm level and the types of services purchased by the firm with soft dollars, and that such information is already captured by most technology management systems of both large and small firms in the Canadian marketplace.

One commenter argued that disclosure at the client level should be for the aggregate of all of a particular client's accounts, and not on an account-by-account basis. This commenter also suggested that only where client-specific goods or services were paid for using soft dollars, these should be specified in any client-specific disclosure. For any goods and services used firm-wide and paid for with soft dollars, a pro-rata amount of this expense should be allocated to the client, using the relation between client assets and total firm assets as a proxy. Another commenter supported the view that a pro-rata approach for allocating services among clients may provide a reasonable compromise for client-level allocation concerns.

iii) Other comments relating to quantitative disclosure

One commenter suggested the minimum level of disclosure should include: total commissions charged to accounts; total directed commissions charged to accounts; total soft dollars earned by accounts; total soft dollar expenditures made by the firm; and soft dollar expenditures broken down by category (i.e., independent research, mixed-use services, bundled research, other). This commenter also suggested that, along with itemizing and describing each soft dollar vendor on a firm-wide basis, the total cost of each service provided should be disclosed (e.g., 17 Bloomberg terminals, data aggregation and analytical tools - \$100,000).

One commenter suggested requiring disclosure of the average dollarized commission rates per unit of security from efficient electronic trading systems as the core commission rate benchmark, compared against the weighted average cost of trades per unit of security in Canadian cents for the current year and 4 previous years.

Another commenter expressed that if the proposed client level disclosure was implemented, commissions should be expressed as a percentage of value rather than in cents/share.

One commenter supported a certain level of statistical disclosure, such as the average commission rates paid, the percentage of commissions executed at full service versus execution-only rates, and the percentage of commissions used for third-party research.

One commenter suggested that minimum standards should be set which include the frequency of disclosure and the scope of information required (e.g., the total amount of commissions used for execution versus other services, the costs of services provided, the allocation and weighting among dealers of the services provided, average/high/low commission rates paid per dealer).

One commenter also made the suggestion that the *Statement of Portfolio Transactions* should be reinstated as an on-request disclosure item.

Response:

In order to attempt to balance the need for accountability and transparency with the need for consistency with disclosure in the U.S., and with the associated burden and costs that might be imposed on advisers, we have determined that one method to achieve this balance would be to expand the proposed narrative disclosure. The proposed narrative requirements would maintain requirements proposed in the 2006 Instrument for disclosure of the nature of the arrangements entered into relating to the use of client brokerage commissions as payment for order execution services or research services, as well as disclosure of the names of dealers and third parties that provided goods and services other than order execution and the types of goods and services they provided. Additional proposed disclosure requirements include a description of the process for, and factors considered in, selecting dealers to effect securities transactions; the procedures for ensuring that, over time, clients receive reasonable benefit from the usage of their brokerage commissions; and the methods by which the determination of the overall reasonableness of client brokerage commissions paid in relation to order execution services and research services received is made. Additional guidance has also been proposed in the Proposed Policy regarding these requirements.

We have also amended the quantitative disclosure requirements that were initially proposed. As an initial step in increasing accountability and transparency through quantitative disclosure, we propose reducing the client-level quantitative disclosure requirements to disclosure of the total client brokerage commissions paid by the client during the period. In addition, we propose requiring disclosure on an aggregated basis of the total client brokerage commissions paid during the period, along with a reasonable estimate of the portion of those aggregated commissions that represents the amounts paid or accumulated to pay for goods and services other than order execution. Guidance has also been proposed in the Proposed Policy regarding the level of aggregation of client brokerage commissions for these disclosure purposes. The proposed guidance allows advisers some flexibility to determine the appropriate level of aggregation based on their business structure and client needs. We believe the quantitative disclosure proposed is relatively consistent with that currently required to be made by investment funds to clients under NI 81-106, except that the proposed disclosure requires the adviser to make a reasonable estimate of the amounts paid or accumulated to pay for goods and services other than order execution, as opposed to requiring disclosure of these amounts to the extent ascertainable.

We will continue to monitor the developments in the U.S., including whether amendments to their disclosure regime are proposed, and are prepared to revisit the approach we have taken at that time.

C. Specific Comments

(a) Separate disclosure requirements for bundled and unbundled services

Some commenters questioned the usefulness of, or had concerns regarding the separate disclosure requirements for bundled and unbundled services. One commenter argued that it is the type of good or service received, not its source, that is most relevant. Other commenters indicated that making the differentiation would discriminate against independent research providers to the detriment of investors and the providers:

- by adding costs for advisers that use independent research;
- by perpetuating the myth that bundled goods and services are somehow unique and should be afforded special status; and
- because it could provide incentives to send trades to dealers for reasons other than best execution.

One commenter was not opposed to the separate disclosure of third party goods and services, and stated that they were already complying with this requirement under NI 81-106.

One commenter questioned the practical application of the third-party disclosure proposed in subparagraph 4.1(1)(c)(iii), as it was that commenter's understanding that an investment adviser likely does not have access to commission sharing arrangements between broker-dealers and third parties, and that it was not clear whether the subparagraph would apply in broker to broker arrangements, for example, through "step out" transactions between an executing and introducing broker. The commenter indicated that in such situations, the adviser is generally not aware of the commission split.

To resolve some of these concerns, five of these commenters suggested that bundled and independent research should be treated the same for reporting purposes. One of these five commenters added that bundled commissions are the least transparent aspect of transactions costs, are estimated to represent a larger share of commissions, and could therefore be misleading to investors if excluded in the quantification of total soft dollar expenditures. This commenter suggested the CSA could either merge the two categories proposed in subparagraphs 4.1(c)(ii) and (iii) and delete the additional disclosure requirements for third party research, or maintain the differentiation but require advisers to make an effort to ascertain from the dealer the amount of proprietary research included in bundled services or to estimate the amount when it cannot be ascertained. Similar suggestions were received from other commenters to break the amounts out following the same methodology as followed under the IMA Pension Fund Disclosure Code in the U.K.

Two other commenters suggested that disclosure of the ratio of the overall cost of research to assets under management, along with a description of the research received, is far more meaningful to investors.

Response:

We agree with commenters that requiring different levels of disclosure for each of these types of goods and services could result in discrimination against those goods and services provided by third parties. The original intention was to require dealers to disclose the amounts which are more readily available and more easily quantifiable.

In revising our proposed disclosure requirements by requiring advisers to make a reasonable estimate of the portion of the aggregated commissions that represents the amounts paid or accumulated to pay for goods and services other than order execution, we have attempted to remove any possible discriminatory results by treating both bundled and unbundled goods and services equally for purposes of this requirement. If it appears that further transparency is required, we will revisit the degree to which the estimate should be broken down further between bundled and unbundled goods and services.

(b) Demand by clients for additional disclosure

One commenter questioned whether there is any evidence to support the proposition that clients demand the proposed level of disclosure, in light of the significant costs. Another commenter indicated it had provided the proposed disclosure on a trial basis to two sophisticated clients, and both clients questioned its usefulness. Other commenters provided details regarding the frequency of requests from clients for additional disclosure relating to soft dollar arrangements and practices:

- three commenters stated that clients are not asking for additional information;
- one commenter indicated that of its hundreds of institutional clients, thousands of private clients, and tens of thousands of mutual fund clients, only 5 clients expressed an interest for more detailed disclosure in the last year; and
- one commenter that represents IC/PMs in Canada indicated that one member that has national presence across Canada has indicated that neither institutional nor private clients have shown any interest in receiving this level of extremely detailed disclosure – and that the company receives approximately 5 requests per year for information on client specific commission usage, none of the requests being from private clients.

To address these concerns, some commenters suggested that clients should be given the option to receive the proposed detailed disclosure, similar to options given under other continuous disclosure requirements such as those relating to financial statements and the Management Report of Fund Performance. Two of these commenters indicated that the practice now is to respond on demand to a client's specific request for disclosure on soft dollar practices, and these commenters believe that not all clients would request the proposed disclosure if given the option, nor would they welcome the associated increase in costs. One of these commenters also stated that if clients were given the option to not receive the detailed disclosure, requirements to provide some general narrative disclosure would be useful to clients, while another commenter suggested that a requirement to disclose the availability of the optional disclosure would be needed to ensure clients were aware of its availability.

A few commenters suggested consulting with clients or forming a task force before disclosure is prescribed. Such consultations were suggested to ensure that the wide spectrum of reporting

arrangements between advisers and clients were given appropriate consideration, and to ensure that clients have had an opportunity to understand the options so that they can determine what disclosure best suits their needs.

Response:

We do not believe that the current requirements under the Existing Provisions, which make the disclosure available upon request, are sufficient to help ensure clients understand how their brokerage commissions have been used for purposes other than as payment for the primary brokerage function. Further, we continue to believe that increased disclosure in this area is necessary to ensure accountability on the part of the adviser relating to the use of these commissions; however, we acknowledge the need to balance the need for more transparency with practicality and have therefore simplified the quantitative disclosure.

(c) *The meaning of “client” in relation to the application of the disclosure requirements*

Some commenters questioned whether disclosure to “clients” was intended to include retail clients of investment funds. One commenter also questioned how to interpret the meaning of “client” for disclosure to clients with private managed accounts or sub-advised accounts, in addition to retail clients of mutual funds. Generally, these commenters did not believe that the proposed disclosure should apply to investment fund clients because:

- these clients already receive appropriate disclosure of soft dollar arrangements under NI 81-106;
- retail clients are typically not in any position to negotiate the management agreements and oversee the adviser’s investment activities;
- the Independent Review Committees (IRC) to be implemented under NI 81-107 will be responsible for managing the conflicts of interest the Proposed Instrument intends to address; and
- disclosure to the individual security holder of investment funds would require a fundamental overhaul of client reporting systems.

Some of these commenters indicated that if, for advisers to investment funds, “client” was intended to mean the fund itself, that this may not be appropriate depending on the fund structure. A couple of these commenters indicated that where the fund is the “client”, the fund is most commonly established as a trust, and the manager is typically the trustee as well as the adviser for the fund. One of these commenters added that, with the exception of Canadian corporate-structure funds, which are few in number, there is no separate fund board of directors or other entity that could properly be considered the adviser’s “client”, as is the case in the U.S. The end result in the situations where the manager is both the adviser and trustee, would be the adviser making the disclosure to itself. The suggestion was made that instead the required disclosure could be made to the IRC. This commenter also added that those funds that have already established IRCs have indicated that these IRCs have been reviewing the firm’s soft dollar policies as part of their oversight role, but have not had any need for additional disclosure.

Another commenter stated that disclosure is only truly useful if those responsible for the funds are required to evaluate the information and ensure that clients’ commissions have been used appropriately and reasonably. This commenter argued that it would not be reasonable to expect the average “person in the street” to read or effectively evaluate the proposed disclosure, and that

it should be trustees, boards of directors, or others with fiduciary responsibilities that should be the target of the disclosure.

Response:

We have proposed guidance under section 5.1 of the Proposed Policy that clarifies that the recipient of the disclosure should typically be the party with whom the contractual arrangement to provide services exists. For example, for an adviser to an investment fund, the client would typically be considered the fund, unless the adviser is also the trustee and/or the manager of the fund, or is an affiliate of the trustee and/or manager of the fund, in which case the adviser should consider whether its relationship with the fund presents a conflict of interest matter under National Instrument 81-107 Independent Review Committee for Investment Funds that requires review by the Independent Review Committee established in accordance with that National Instrument, and whether it would be more appropriate for the disclosure to be made instead to the Independent Review Committee. Disclosure to retail clients of mutual funds about the use of their commissions would be governed by the provisions of NI 81-101 and NI 81-106, and any other relevant provisions.

Question 13: Should periodic disclosure be required on a more frequent basis than annually?

Most commenters believe that annual disclosure should be sufficient. One suggested that more frequent disclosure could cause a false sense of volatility as accounts, mandates, and soft dollar budgets often change on an annual basis. Another commenter indicated that while they have already been reporting to clients annually on the details of goods and services paid for with commission dollars, there have been no requests for more frequent reporting.

Alternative suggestions for the frequency of disclosure provided by a couple of commenters included:

- as often as the client and adviser complete a performance review;
- on a semi-annual basis, as required for the IMA Level II disclosure requirements; or
- on a regular and consistent basis, in particular to the Boards, Trustees, or other persons with oversight responsibilities for advisers.

Response:

We agree with the view of most commenters that periodic disclosure is not required on a more frequent basis than annually.

Question 14: What difficulties, if any, would an adviser face in making the disclosure under Part 4 of the 2006 Instrument?

A. General comments

Commenters were generally concerned that the proposed disclosure requirements would be difficult to meet, and believe that these difficulties would result in costs that exceed any benefits to clients. Various commenters were specifically concerned with the requirement to make

disclosure by client, and by security class, particularly for smaller firms. Reasons for, or causes of, the difficulties that were provided include:

- systems do not currently track the amount paid out as soft dollars for a given service on behalf of each individual account;
- goods and services are often obtained at a macro level for the benefit of multiple clients, not at the client level, resulting in imprecise allocations at the client level, and the benefits to clients may change over time;
- trading activity is often conducted for multiple clients at once, or through pooled investment funds, so providing data at the individual client level would be burdensome and would be further complicated when mixed-use goods and services are involved;
- dealers providing bundled services are not required, and have not taken measures, to provide information on bundled goods and services to advisers;
- trading activity and the payment for goods and services do not always occur at the same time;
- more than one dealer may be used to pay a single third-party service invoice;
- fees on trades in foreign jurisdictions may not be charged on a “per unit” basis, but rather as a percentage of trade value;
- currently available software packages that may address U.K. and U.S. requirements are not currently configured to address the proposed Canadian disclosure requirements; and
- relying on third-party software vendors could result in the reporting of inaccurate information, which the adviser will still have to reconcile.

However, as noted earlier, one commenter indicated that disclosure of the total value of commissions used, the types of services purchased with soft dollars, and the percentage of client commissions allocated to soft dollars in each client’s account(s) should not be difficult as such information is already captured by most technology management systems of large and small firms in the Canadian marketplace.

Response:

We note that the general comments relating to difficulties with meeting the disclosure requirements in the 2006 Instrument centre around difficulties with meeting the client-level and security-class-level disclosure. Due to the lack of precision regarding costs for bundled services, as well as timing differences between the trades that generate the commissions and the payment with those commissions for the goods and services, we agree that the detailed disclosure would be difficult to make with any degree of accuracy. We believe the amendments that we are currently proposing, discussed earlier under the response to Question 12, should address these general concerns.

B. Specific comments

(a) Requirements under subsection 4.1(2) of the 2006 Instrument

Many commenters indicated that the proposed requirements under subsection 4.1(2) to maintain specific details of the goods and services would be difficult, onerous and costly to track for the following types of goods and services:

- bundled services where no separate paper trail exists for the additional goods and services;
- intangibles that constitute research, such as communications with dealers by telephone, e-mail, mail, and in-person meetings; and
- items received on an unsolicited basis.

Some commenters also questioned the usefulness to clients of this proposed requirement. Reasons included that such an approach is inconsistent with an adviser's view toward measuring the overall benefit to its clients of the services received, and that such details would have little relevance to any one client.

Others suggested that the general requirement on all advisers to maintain adequate books and records is sufficient, and that advisers should be permitted the flexibility to determine how to document the goods and services received, so long as the records provide adequate documentation that only permissible uses were made of client brokerage commissions. Another commenter suggested that a concept of materiality could be introduced to manage the level of detail maintained under this proposed requirement, while another suggested adding a requirement that dealers must provide advisers with the needed information.

However, three commenters were not opposed to this proposed requirement, although one of these questioned how an investor would or could use this information. One commenter suggested the details could be maintained as a supplement to the narrative disclosure proposed in paragraph 4.1(a), so long as the quantitative disclosure was removed, while another commenter suggested that if such details were to be maintained, clients should be advised of the availability of the details, for example by a prominent note in a fund prospectus or in the Management Report of Fund Performance.

Response:

We believe that disclosure of the names of service providers and types of goods and services that is required under paragraph 4.1(c) of the Proposed Instrument should generally provide clients with sufficient detail relating to the specific goods and services paid for with client brokerage commissions. On this basis, we have removed the requirement previously proposed under subsection 4.1(2) of the 2006 Instrument to maintain, and make available upon request, more specific information about the goods and services received.

Despite removal of this explicit requirement, advisers are reminded of the general requirement to maintain adequate books and records in order to be able to demonstrate compliance with the Proposed Instrument.

(b) *Differences in disclosure requirements between the 2006 Instrument and the U.S. and U.K.*

Various commenters noted the differences between the proposed disclosure and the requirements in the U.S. and U.K., and some believed the disclosure in the 2006 Instrument was more stringent. Most of these commenters suggested that disclosure requirements in Canada should more closely resemble those in the U.S., or the U.K. (including the Level I and Level II of the IMA Disclosure Code). Reasons provided in support of this suggestion included that:

- more consistency would allow firms that report to clients in different jurisdictions to standardize their reporting processes;
- the information to be disclosed under the IMA Disclosure Code would provide plan administrators and trustees with the information needed to assess value from their commission spend;
- it may be difficult for Canadian advisers to obtain all relevant information from U.S. sub-advisers; and
- disclosure requirements should be market guided as in the U.K., and not prescriptive.

One commenter suggested a flexible disclosure regime should be permitted given that advisers currently take various approaches to disclosing brokerage practices, which often already includes following either of the U.S. or U.K. disclosure requirements.

Response:

We agree that imposing different disclosure requirements than other jurisdictions regarding the subject matter of the Proposed Instrument could cause difficulties for advisers that report to clients or hire sub-advisers in multiple jurisdictions. As stated earlier, we believe that harmonization with other jurisdictions is appropriate where justifiable to do so, and we understand that there is a general preference for harmonizing with the U.S., as opposed to the U.K.

However, the current disclosure requirements in the U.S. under the SEC's Form ADV Part II and Form N-1A that specifically address the use of client brokerage commissions for purposes of obtaining goods and services other than order execution centre primarily around narrative disclosure, and we believe that a certain level of quantitative disclosure should be included. At one point, the SEC had indicated they would be issuing proposed amendments to their disclosure regime, but we are unaware of any such proposal having been made to date. As noted earlier, we will continue to monitor the developments in the U.S. regarding whether amendments to their disclosure regime are proposed, and are prepared to revisit the approach we have taken at that time.

- (c) *Disclosure of dealer and supplier names, along with the types of goods and services provided*

A few commenters indicated that requiring disclosure of the names of dealers and suppliers utilized by the adviser would result in the disclosure of proprietary information which could negatively impact an adviser's competitive advantage – particularly in relation to competitors in foreign jurisdictions that are not required to disclose this information.

It was also stated that providing the names of all dealers and all types of goods and services provided by each of the dealers would be duplicative given that advisers can obtain the same types of services from different dealers (e.g. traditional research reports) and, for clients with global investment mandates or for investors in global funds, this disclosure could extend to over 100 dealers – which would cause tracking difficulties and result in lengthy reporting.

A few commenters also suggested that such disclosure would not be useful to clients, and that providing information on the types of broker-dealers used was more relevant.

Response:

We note that there is an existing requirement for investment funds to provide similar disclosure to the public in the Annual Information Form under Form 81-101F2. For advisers, other than those whose clients are investment funds where similar public disclosure requirements are imposed on the fund itself, this disclosure would be made to the client and not to the public in general. As a result, we question the degree to which competitive advantage would be harmed from such disclosure. We continue to think such disclosure would be useful to clients as it would help them to better understand the ongoing use of their brokerage commissions, while increasing accountability on the part of the adviser. We have made amendments to the Proposed Instrument to clarify that such disclosure would be required in those situations where goods and services other than order execution have been provided, and to add that associating the types of goods and services received to each dealer or third party that provided that good or service is not necessary, except in the case of goods and services provided by affiliated entities. Affiliated entities and the types of goods and services each such entity provided should be separately identified. We have also added guidance to the Proposed Policy to provide the adviser with some flexibility as to the scope of the disclosure to be provided to clients in relation to this requirement.

(d) *Application of disclosure*

Another commenter suggested that it was not clear how the requirement for advisers to make certain disclosures, if they enter arrangements with dealers to use client commissions “as payment for” services other than order execution, should be applied in relation to bundled services. This commenter indicated that the payment of brokerage commissions to dealers that also provide research services should not constitute a “payment for” research. This commenter suggested that other factors should be present in order for commissions to be deemed to include a payment for research, such as an agreement to pay higher commission rates than the dealer otherwise charges, or a commitment to execute a specified trading volume. This commenter recommended that bundled brokerage transactions that do not include a binding commitment to pay for research should be excluded from the disclosure requirements. Another commenter stated that when “soft dollar” arrangements are made between an adviser and a dealer, there must be a soft dollar agreement completed and kept on file by both parties.

Another commenter suggested that if brokerage commissions paid out of a particular client account were never to be used as payment for goods and services other than order execution, the adviser should not be required to disclose to that client the brokerage commissions generated by the firm, or the nature of soft dollar arrangements entered into by the firm in relation to other clients.

Response:

Section 4.1 of the Proposed Policy includes the statement that the Proposed Instrument applies in the cases of both formal and informal arrangements, including those informal arrangements for the receipt of such goods and services from a dealer offering proprietary, bundled services. As a result, the disclosure requirements also extend to client brokerage commissions used in informal arrangements with dealers offering proprietary, bundled services. We believe the amendments made to the disclosure requirements should be sufficient to address the concerns

raised by commenters relating to the difficulties involved in complying with the Proposed Instrument when such arrangements are in place.

To the extent that an adviser can isolate a client account, or a group of client accounts, from its other clients whose brokerage commissions are used as payment for goods and services other than order execution, the adviser would not be required to make the disclosure to these clients.

However, given that the disclosure requirements apply whether the arrangements under which client brokerage commissions used are formal or informal (including those with dealers offering proprietary, bundled services), it may be difficult to support a claim that brokerage commissions paid by a particular client would never be used as payment for goods and services other than order execution if commissions charged to that client have been paid to a dealer that provides the adviser with proprietary, bundled services.

Question 15: Should there be specific disclosure for trades done on a “net” basis? If so, should the disclosure be limited to the percentage of total trading conducted on this basis (similar to the IMA’s approach)? Alternatively, should the transaction fees embedded in the price be allocated to the disclosure categories set out in sub-section 4.1(c) of the 2006 Instrument, to the extent they can be reasonably estimated?

Most commenters reiterated the views they expressed in response to Question 1 that the Proposed Instrument should not apply to securities traded on a principal basis. They noted that determining the commissions on a principal basis presents problems unless published bid-ask spreads are recorded on the trade contract.

Some commenters thought that, if the Proposed Instrument were to apply to trades done on a “net” basis, the approach for disclosure should be similar to that taken by the IMA, i.e. the disclosure should be limited to the percentage of total trading conducted on this basis. The reasons given were that there is no generally accepted method of breaking out commission fees and, given the inherent lack of precision in identifying the amount of embedded commissions, any approach to establishing commissions will be an approximation at best. One commenter thought that the clearest disclosure is achieved by applying a percentage to the aggregate amount of principal trading. However, another respondent thought that the reporting of data using estimates should be discouraged or at least supplemented with further guidance on what is, and is not, reasonable.

Response:

We have reduced the scope of the application of the Proposed Instrument to apply only to those trades where brokerage commissions are charged (i.e., where a commission or similar transaction-based fee is charged and the amount paid for the security is clearly separate and identifiable). See the response to Question 1 above for more information.

II. Other Comments

Transition period

Various commenters believed that a transition period is necessary. The more common reasons given included that:

- mixed-use service providers would need time to adjust their invoicing practices, as was suggested is currently being done in the U.S. as a result of the SEC's 2006 Release;
- advisers would need time to assess their existing practices to identify gaps and make any necessary changes;
- many traditional soft dollar arrangements are negotiated on an annual basis;
- changes would need to be made to accounting and reporting systems to meet the more detailed disclosure requirements;
- other CSA initiatives include a transition period; and
- the SEC and FSA had permitted a 6-month transition period.

One commenter suggested that major changes in processes for brokers, advisers and clients will be required, given that existing procedures are the consequence of a half century of industry practice and tradition. This commenter also noted that existing procedures, or the lack thereof, are deeply embedded. This commenter believes that the 2006 Instrument would lead to more "execution only" trading and dealers would have to implement competitive business plans to address "unbundling", so it would take several quarters to establish competitive pricing. In addition, this commenter suggested that although there are vendors that specialize in commission management software, it would still take time for advisers to identify needs and fully establish the necessary systems.

Further this commenter argued that clients may not have a complete appreciation of the related governance issues, and the introduction of the 2006 Instrument would represent a new and material addition to trustee oversight responsibilities. The process of education and consultation by trustee/investment boards will require considerable time to fully assimilate and complete. This commenter recommended that milestones be established in consultation with dealers, advisers and clients, for example: the date advisers should have completed commissions usage policies; the date aggregate commission payment arrangements are disclosed to clients and regulators; and the date by which the advisers will be in full compliance with the Proposed Instrument, including the proposed detailed disclosure.

Another commenter stated that any transition period should allow for advisers to initially make the prescribed disclosure on a best efforts basis, followed by a more rigorous standard when compilation and allocation of the data is possible.

Response:

We have amended the Proposed Instrument to include an effective date which is six months after the Proposed Instrument's approval date.

We believe that the amendments made to the Proposed Instrument, including the removal of some of the more onerous reporting requirements, should address many of the commenter concerns, and therefore a longer transition period should not be needed.

Costs

Some commenters did not believe the estimate of costs in the Cost Benefit Analysis was realistic, and that any benefits that might accrue to clients would not exceed the costs. Reasons for these views included:

- the technology costs associated with modifications to existing trade order management and compliance systems to monitor, track, allocate and report soft dollars was not considered;
- there would be human resource costs associated with hiring and training new compliance, investment management and back-office personnel to administer the process contemplated by the 2006 Instrument;
- there would be costs associated with ensuring ongoing compliance; and
- there would be indirect costs passed on to advisers by sub-advisers from other jurisdictions in order to comply, either directly or indirectly, with the 2006 Instrument.

Two commenters added that the increase in costs for advisers, and for service providers that will have to modify their own processes, will ultimately be passed on to clients through higher transaction costs or management fees. In addition, the higher fixed costs from transferring formerly permissible goods to non-permissible may also result in higher barriers to entry, or have other detrimental impacts on smaller investment management firms seeking to compete with larger firms.

One commenter raised a concern that firms that hold assets for their clients on a segregated basis will have a higher cost of compliance, which will further increase the fee gap between segregated and pooled products.

Response:

We believe that the amendments we have made to the Proposed Instrument should help to address many of the above concerns relating to costs, in particular those relating to disclosure. We do not believe that the costs of complying with the non-disclosure-related requirements of the Proposed Instrument will be significant for firms that have been complying with the Existing Provisions. There have been little or no changes to the definitions of order execution services and research services from the Existing Provisions, and in accordance with the general principles of acting in the best interests of clients, we would expect that advisers are currently monitoring and tracking the use of client brokerage commissions to some degree.

Allocation of benefits to clients

Some commenters raised concerns with the proposed requirement to ensure that the order execution services or research acquired are for the benefit of the adviser's client(s), and with the related guidance that states that advisers should have adequate policies and procedures in place to allocate, on a fair and reasonable basis, the goods and services received to clients whose brokerage commissions were used as payment for those goods and services.

Some commenters believe the requirement and guidance imply that there must be a direct connection between the specific good or service received and the client whose account generated

the commissions that paid for that specific good or service, even though the goods and services received typically benefit a number of clients and may not always benefit the specific account that generated the commissions. One commenter added that the standard would require an adviser to ignore or unlearn the information or knowledge gathered through research acquired with one client's commissions when making decisions for another client.

Another commenter argued that the more that goods and services are bundled together with order execution, the more difficult it is to determine if the commission dollars paid have been allocated correctly to the clients who have received the benefit.

It was suggested by one commenter that the requirement should be revised to require that the goods or services benefit "one or more of" the adviser's client(s).

Response:

We acknowledge that goods and services received typically benefit a number of clients and may not always be specifically matched, dollar-for-dollar, to each client account generating the commissions. We have amended the guidance provided under Part 4 of the Proposed Policy to clarify 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. However, 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.

Unsolicited goods and services

Some commenters questioned whether the requirements under the Proposed Instrument and Proposed Policy would apply to unsolicited goods and services. Concerns raised in relation to unsolicited goods and services arose because of either the proposed requirement for advisers to evaluate goods and services received against commissions paid, or the proposed disclosure requirements.

Two commenters indicated that advisers often do not have the discretion to negotiate which goods and services will be received in conjunction with a bundled services offering. They both raised the concern that without any cost information from the dealers or any reliable mechanism for separating the component parts, it would be difficult and costly for an adviser to estimate the value of any unsolicited services received, and in some cases, this could not be done with any degree of fairness or accuracy.

Another commenter indicated that because of the way that dealers offer and deliver information to their clients today, it is inevitable that advisers will have access to and obtain, on an incidental basis, information and materials from the entities with whom they place client orders. This commenter indicated that a problem then arises when all or a portion of the information and materials made available to, or received by, an adviser are not permitted to be obtained in consideration of client commission dollars. For example, in some cases advisers have access to a protected website to collect daily research reports, but the site also includes information that does not satisfy the definitions of research or order execution services. In addition, a dealer might

send its clients copies of articles or other newsletters that may not be considered research. This commenter suggested that so long as an adviser is not taking such incidental services into consideration when making its evaluation of the dealers services in relation to the commissions paid, then the availability or receipt of the goods and services in question should not be perceived as a violation of the Proposed Instrument. This commenter also noted that an adviser might, however, violate their fiduciary duties if this approach was taken too far.

Another commenter echoed some of the same concerns regarding goods and services being made available by, but not purchased from, a bundled service provider, which could include eligible and ineligible services that may not be a factor in a particular adviser's decision to place trades with that particular bundled service provider. A money manager may have selected a specific broker-dealer to execute trades based upon its skill in placing a difficult trade, its position in the market, or any of the myriad of factors considered when evaluating best execution. In those cases where a dealer includes, as part of its bundled offering, research and/or services not requested or used by a money manager, the commenter argues the traditional elements of a "soft dollar" arrangement are not present, and the framework set forth in the Proposed Instrument should not apply. In addition, this commenter argued that there are no inherent conflicts of interest when the adviser is being provided goods or services on an unsolicited basis which they will not use, but acknowledges that to the extent the adviser uses those unsolicited goods and services, the requirements of the Proposed Instrument should apply. Another commenter had similar concerns, but suggested that advisers and regulators should instead consider whether there is an explicit commitment to execute a minimum volume of orders through the broker to pay for research, when determining whether commissions paid by an adviser include payments for research.

One commenter requested that the CSA clarify whether an adviser must disclose soft dollar transactions when not asking for, or using the additional services, or if unaware that the services are bundled.

Response:

We appreciate the difficulties involved with complying with the Proposed Instrument when goods and services are received on an unsolicited basis, particularly when received as part of a bundled services offering.

We have amended the Proposed Policy to provide additional guidance with respect to unsolicited goods and services in relation to an adviser's obligation to ensure that a good faith determination has been made that the amount of client brokerage commissions paid for order execution services or research services is reasonable in relation to the value of the order execution services or research services received. This determination can be made either with respect to a particular transaction or the adviser's overall responsibilities for client accounts. The relevant measure for any such determination is the reasonableness of the amount of client brokerage commissions paid in relation to the order execution services and research services received and used by the adviser. An adviser that, by virtue of paying client brokerage commissions, is provided with access to goods and services, or receives goods or services on an unsolicited basis and does not use such items, will not be considered to be in violation of its obligations if it does not include these in its assessment of value received in relation to commissions paid. To the extent that an adviser makes use of any such goods or services, or

considers the availability of such goods or services a factor when selecting dealers, the adviser should include these in its assessment of value received for commissions paid.

We think this guidance should also apply when making allocations with respect to a mixed-use good or service. An adviser would not be required to allocate cost to, and pay with its own funds for, an ineligible portion of a good or service received on an unsolicited basis that was not used. However, in this case, in our view the adviser would still have the obligation to make a good faith determination that the amount of client brokerage commissions paid was reasonable in relation to the value of the eligible portion of that good or service received.

We also think this guidance can similarly be applied to determinations in relation to the disclosure of information about unsolicited goods and services.

Principles-based approach

A few commenters questioned the approach taken by the CSA and suggested that a principles-based approach was more appropriate. Reasons for this view included that:

- principles-based regulation, coupled with meaningful oversight, is more effective than rule-based regulation;
- principles are clear to the vast majority of honest operators; and
- lists would be cumbersome and unworkable, and that the principles-based approach has worked well in the U.S.

Suggestions made by these commenters included:

- allowing advisers, the users of the services, the flexibility to determine which services assist them in the investment decision-making process, while acting within their fiduciary duty;
- establishing key principles based on use to govern what goods and services can be purchased with commissions, rather than relying on a narrowly defined rule set, and to ensure adequate disclosure to investors;
- providing principles-based interpretations of soft dollar arrangements through the use of practical examples, case studies, and illustrations of real-life soft dollar situations that meet or do not meet the objectives of fair, honest and transparent dealings with clients;
- including an overall objective to the Proposed Instrument to expressly align the interests of the investor and the advisers, which would serve as the underlying guiding principle that can protect the investor and retain the flexibility necessary to allow innovation.

One commenter suggested that other than defining the key criteria for determining whether a good or service should be eligible, the role of a National Instrument should be to identify the specific goods and services that require special assessment as to their eligibility because the determination is not clear cut, and in cases where an adviser utilizes these services, it should be required to provide detailed disclosure that demonstrates why the good or service is appropriate in the context of its investment management process and the arrangements it has with clients.

Another commenter also added that the CSA notice did not indicate whether deficiencies in regulatory reviews of advisors have identified problems to require implementation of a rule.

Response:

We have essentially reformulated the Existing Provisions into a National Instrument. One of the objectives of creating the Proposed Instrument was to provide consistent requirements across Canada, as the Existing Provisions only apply in two provinces and only have force of rule in Quebec. The objective of creating the Proposed Policy was to provide additional guidance that would assist advisers in complying with the Proposed Instrument, including examples of goods and services that may be considered to be order execution services or research services.

In addition, we note that for several years, the annual reports published by the Compliance Department of the OSC's Capital Markets Branch have made reference to the identification of issues relating to soft dollars as a result of the compliance reviews performed.

However, we have made some amendments to the Proposed Instrument and Proposed Policy that we believe provide the adviser with greater flexibility to make determinations regarding its own compliance with the Proposed Instrument. In addition, we believe that the approach we have taken in addressing the issues and concerns is not inconsistent with the approaches taken in other jurisdictions. Both the U.S. and U.K. identified similar issues and concerns; the U.S. issued new interpretive guidance to clarify the safe harbor provided under Section 28(e) of the Securities Exchange Act, and the U.K. finalized new rules and guidance, both of which contain lists of the types of goods and services they might consider eligible under their respective requirements / legislation in order to add clarity. Further, while we acknowledge that there may be differences in practices relating to the use of client brokerage commissions between advisers in Canada and these other jurisdictions, the common objective amongst the various jurisdictions is to address the inherent conflicts of interest associated with the use of client brokerage commissions for payment for goods and services other than order execution, which should therefore necessitate a similar approach and response, where justifiable.

Temporal Standard for “Order Execution Services”

In the course of responding to the questions relating to post-trade analytics and OMSs, a few commenters stated their views on the temporal standard proposed for “order execution services”.

One commenter noted that the CSA had proposed a temporal standard which differs from that of the SEC, but agreed that order execution services start at the time an investment decision is made as opposed to starting at the time an order is communicated to a dealer (as is the case in the U.S.). This commenter noted that this starting point would correspond with the entry of an order into an order management system.

The above view was supported by another commenter that stated that order execution services should include technology and services which assist in the execution of an order from the point at which the order life cycle starts (after the investment decision is made), and its reasoning for inclusion of post-trade analytics as order execution services included that the information gained from the measurement of the quality of execution can be used to make trading decisions. Two other commenters also justified inclusion of post-trade analytics as order execution services on the basis that they assist with the decisions of when, where and how to trade.

Another commenter was concerned that the temporal standard for “order execution services” as defined in the 2006 Instrument and 2006 Policy is contrary to long-standing industry practice. This commenter believed that the 2006 Policy indicated that “order execution services” means the entry, handling or facilitation of an order by a dealer, but not other tools that are provided to aid in the execution of trades, and on the basis of that belief, stated that the CSA has traditionally defined “order execution more broadly, leading market participants to develop a practice of paying for certain products, such as order management systems, with soft dollars as advisers use these to model, prepare and analyze prospective trades prior to the moment the trade order button is pushed”.

Response:

We have clarified the temporal standard in the Proposed Policy to indicate that we would generally consider that goods and services directly related to the execution process would be provided or used between the point at which an adviser makes an investment decision (i.e., the decision to buy or sell a security) and the point at which the resulting securities transaction is concluded. We have removed the word “trading” from the previously published starting point for the temporal standard of ‘after the investment or trading decision is made’ in order to clarify that to the extent that a good or service assists the adviser with determining the how, when or where to execute a transaction, we would consider this to be part of the order execution process, which should therefore fall within the temporal standard for order execution services as being directly related to order execution. This allows for consistency in the categorization of goods and services involved in the execution process regardless of the extent to which the adviser relies on the dealer for execution decisions, or contributes to or makes the decision itself.

In addition, we have also clarified in the Proposed Policy that for the purposes of the Proposed Instrument, the term “order execution”, as opposed to “order execution services”, means the entry, handling or facilitation of an order whether by a dealer or by an adviser through direct market access, but not other goods or services provided to aid in the execution of trades – these other goods and services could be considered “order execution services” to the extent they are directly related to order execution and meet the temporal standard. This clarification in relation to an adviser’s involvement with the entry, handling or facilitation of orders is intended to again allow consistency in the categorization of goods and services in those situations where an adviser is performing these functions itself through direct market access and is not reliant on the dealer for the execution.

While the temporal standard may be different than the standard used by the SEC, we do not believe the difference should cause any issues regarding the eligibility of particular goods or services between jurisdictions. Rather, there should only result in differences in how an eligible good or service has been categorized between the two jurisdictions; for example, a good categorized as research under the SEC’s temporal standard, might be categorized as order execution services under the Proposed Instrument.

“Soft Dollars” Terminology

One commenter suggested that the definition of “soft dollar arrangements” does not traditionally include bundled services arrangements, and that to combine bundled and third-party arrangements under the same terminology could be confusing.

Three commenters believe the term has a negative connotation, as a result of public misuse and, at worst, could suggest unethical or even illegal behaviour. Two of these commenters noted that the FSA and SEC have dropped use of the term “soft dollars”.

Response:

The Proposed Instrument does not materially change the scope of the services included as soft dollar arrangements from that in the Existing Provisions. The Existing Provisions specifically refer to bundled services – by including the statement “whether the services are provided by a dealer directly or by a third party” in relation to the definitions of both “order execution services” and “investment decision-making services”.

However, to help reduce any confusion on this point, and to address the other concerns raised, we have amended the Proposed Instrument to remove reference to the term “soft dollar arrangements”.

Related-party soft dollar transactions

One commenter stated that soft dollars should not be permitted between related parties, and that these should be purchased at market rates and funded by the management fee.

Response:

We believe that any concerns relating to related-party transactions involving soft dollar arrangements can be adequately addressed through disclosure. The amendments made to the disclosure requirements include identification of affiliated entities and the services they provided.

Application of Proposed Instrument to sub-advisers

One commenter requested clarification on whether the Proposed Instrument would apply when a Canadian registered investment adviser has delegated full discretionary investment management authority to a non-Canadian registered affiliate.

Other commenters had raised concerns regarding the difficulties or costs involved with obtaining information from sub-advisers in order to meet disclosure requirements.

Response:

As stated in section 2.1 of the Proposed Policy, the term “advisers” includes registered advisers and registered dealers that carry out advisory functions but are exempt from registration as advisers. A foreign sub-adviser that is not required to register in Canada by virtue of an exemption is therefore not itself subject to the Proposed Instrument.

Regarding the disclosure required under the Proposed Instrument, an adviser registered in a provincial jurisdiction where this Proposed Instrument has been adopted would be responsible for the disclosure being made to a client in relation to the use of its client brokerage commissions by a sub-adviser, whether the sub-adviser is registered in one of these provinces or not; the disclosure requirements relate to the use of the client brokerage commissions themselves.

Other requests for clarification

One commenter indicated that some advisers seem to believe that they must limit the amount of independent or discretely priced research that they acquire, while they are not limited in the amount of proprietary research they receive from full-service brokers on a bundled basis. This commenter believed it would be helpful if the CSA made the statement that no such limit exists or is warranted, and that placing arbitrary percentages on any exposure to research is potentially harmful to the end investor.

Response:

In the notice that accompanied the 2006 Instrument, we stated that we believe that the forwarding of client brokerage commissions by dealers to third parties should be permitted in order to provide flexibility and promote the use of independent research. We also stated that we agreed with commenters to the Concept Paper that there should be no difference in the eligibility of these services based on who provided them. These statements should not be interpreted to mean that advisers should limit the amount of independent or discretely priced research that they acquire.

List of commenters

1. Accountability Research Corporation
2. AGF Funds Inc.
3. Alternative Investment Management Association – Canada Chapter
4. Baillie Gifford & Co.
5. Barclays Global Investors Canada Limited
6. British Columbia Investment Management Corporation
7. Bloomberg L.P.
8. BNY ConvergEx Group LLC
9. Canadian Advocacy Council

10. Canadian Bankers Association
11. Capital International Asset Management (Canada) Inc.
12. CIBC
13. Commission Direct Inc.
14. CPP Investment Board
15. Cumberland Private Wealth Management Inc.
16. Fidelity Investments Canada Limited
17. First Coverage Inc.
18. Greystone Managed Investments Inc.
19. Heathbridge Capital Management Ltd.
20. Highstreet Asset Management Inc.
21. Hillsdale Investment Management Inc.
22. Investment Adviser Association
23. Investment Counsel Association of Canada
24. Investment Company Institute
25. The Investment Funds Institute of Canada
26. IGM Financial Inc.
27. Investment Industry Association of Canada
28. ITG Canada Corp.
29. Kenmar
30. McLean Budden Limited
31. National Society of Compliance Professionals Inc.
32. Pacific Capital Management Ltd.
33. Perimeter Financial Corp.

34. Phillips, Hager & North Investment Management Ltd.
35. Raymond James Ltd.
36. RBC Asset Management Inc.
37. Reuters Canada Limited
38. TD Asset Management Inc.
39. TD Newcrest
40. T. Rowe Price Associates, Inc.
41. TSX Group Inc.
42. Veritas Investment Research Corporation
43. Wirth Associates Inc.