APPENDIX B

Cost-Benefit Analysis

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

Introduction

On July 21, 2006, the Canadian Securities Administrators (CSA) published for comment proposed National Instrument 23-102 – *Use of Client Brokerage Commissions as Payment for Order Execution Services or Research*. Along with the Proposed Instrument, the CSA published a cost-benefit analysis prepared by the Ontario Securities Commission. This revised cost-benefit analysis incorporates changes to the Proposed Instrument and Proposed Policy.

Background

The cost of investment management is typically recovered from an adviser's client through management fees and the pass-through of dealer commissions. Trading commissions are paid directly from the client's funds and are also used to pay for bundled and third-party services such as investment research, access to analytical tools, etc.

From a theoretical perspective, bundling goods or services can generate economic benefits[1]. For example, it can allow for economies of scope in their production, resulting in the combined price being lower than the aggregate price of the individual items. From the purchaser's perspective it can be cheaper to buy a combined product as opposed to separately finding each individual part. Bundled products can also result in more efficiently set prices that reflect the value that different purchasers are willing to pay.

It can be argued, that payments to third-parties via brokerage commission arrangements support providers of independent investment research. These arrangements can make it easier for research providers to gain access to advisers and can result in lower barriers to entry than would otherwise exist. More research providers and greater competition amongst them results in increased choice and better quality research. Improved investment decisions and the associated increased investment returns ultimately benefit investors.

The use of trading commissions to purchase goods and services other than order execution effectively lowers the cost of market entry for advisers. This should encourage more market entrants and increase competition among advisers. Allowing execution and research services to be paid with brokerage commissions also creates an incentive for

[1] Financial Services Authority, CP176: Bundled brokerage and Soft Commission Arrangements, April 2003, pg 18-19.

advisers to consume such services so as to increase the effectiveness of their investment decision making.

However, conflicts of interest can arise from the use of client brokerage commissions to purchase goods and services which can benefit the client and the adviser to different degrees. As the adviser's incentives may not align with those of the client, the result may be an inefficient allocation of resources.

This occurs for at least two reasons: investors are unable to compare investment management services based upon trading costs and the use of client brokerage commissions; and investors are also unable to monitor trading decisions to ensure they are made in their best interests and not those of the adviser. Economists refer to this lack of transparency from the investor's perspective as information asymmetry[2].

The information asymmetry creates a number of regulatory concerns:

- An adviser's use of trading commissions to purchase bundled or third-party goods is not transparent. Investors are unable to properly monitor their adviser's decisions and evaluate if they are getting value for their money.
- Advisers may over-consume goods and services acquired with commission payments. These items may be acquired for an excessive price and/or in excessive quantities and may not benefit the client.
- Arrangements to use brokerage commissions to purchase bundled or third-party services create an incentive to base trading volumes on access to those services.
- Trading decisions, such as broker selection, may be based upon the adviser's commission arrangements and not the best interests of the client.

The scope of the issue

Based on research by Greenwich Associates, of the estimated $790 million in equity trading commissions paid in 2006-2007, approximately $442 million (56%) was paid to investment dealers for non-execution goods and services and $55 million (7%) was paid to third-party service providers[3].

The key stakeholders in brokerage commission arrangements are:

- Advisory firms. Across Canada there are approximately 940 firms registered to provide investment advisory services to investors[4]. A high proportion of these firms would receive dealer bundled goods and services[5].

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[2] Information asymmetry occurs when one party to a contract has more complete information than the party on the other side. Typically the seller is better informed.

[3] Greenwich Associates, "Canadian Equities: Amid Booming Market, Institutions Put some Strategic Moves on Hold", August 2007.

[4] This figure represents the number of firms in National Registration Database (NRD) that are registered in an adviser category. The NRD information is as of October 3, 2007.

[5] This is based upon anecdotal evidence and Greenwich's research that shows that bundled goods and services are far more prevalent (56% of commissions allocated for bundled services as opposed to 7% for third-party research).

- Investment dealers. As of the first quarter of 2007 there were 199 investment dealers in Canada[6]. All dealers can offer their clients bundled proprietary goods and the option of directing commission payments to third-party providers.
- Vendors of research or other services who receive payment for their products through brokerage commission arrangements with dealers.
- Investors who use an adviser to manage their portfolio are indirectly affected.

Is there evidence of a need for regulatory action?

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

Between 2003 and 2007, OSC compliance staff found deficiencies in 35% of the 31 firms reviewed that used commissions to purchase third-party products[7]. Over the same period, the British Columbia Securities Commission's (BCSC) compliance staff identified seven deficiencies, only one of which they considered serious, in 23 Investment Counsel/Portfolio Manager firms that had soft dollar arrangements[8].

Although there is little evidence of deliberate abuses of brokerage commission arrangements within Canada and globally[9], this may result from a largely opaque environment where only institutional investors are able to monitor trading. Nonetheless, concerns over the inherent conflicts of interest are well documented[10] in the research and have lead regulators in the U.K. and the U.S. to take action.

Research by Greenwich Associates suggests that 71% of Canadian investment managers would decrease their use of sell-side research if forced to pay for it with hard dollars[11]. One could infer from this that advisers do not attach much value to this research and are, at least inadvertently, over-consuming it under current brokerage commission arrangements. It may also mean that investors are potentially over-paying brokerage commissions that fund research their advisers do not value.

The Greenwich Associates research also shows that advisers use client brokerage commissions to purchase goods and services that may not meet the proposed definition of execution services and research services[12]. Investors may be paying for goods and

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[6] Investment Industry Association, Securities Industry Performance, First Quarter 2007.
[7] From April 2003 to March 2007, the OSC performed compliance reviews of 85 firms registered as investment counsel/portfolio managers (ICPM). 31 of those firms had soft dollar arrangements to purchase third-party goods and services. Of those, deficiencies were found at 11 firms.
[8] From 2003 to 2007, the BCSC performed compliance reviews of 90 firms registered as ICPMs. Of those, 23 were found to have soft dollar arrangements.
[9] Consultation Report: Soft Dollars, International Organisation of Securities Commissions, November 2006.
[10] For example, the UK Myners reports (Institutional Investment in the United Kingdom: A Review, HM Treasury, March 2001).
[11] Greenwich Associates, "Canadian Equities: Setting the Price for Sell-Side Research", June 2005, pg 5.
[12]Ibid, pg 4.

services that the CSA would not consider sufficiently linked to the investment decision-making process, such as newspaper subscriptions.

Will market forces sufficiently manage this issue?

The 2007 Greenwich Associates report indicates that the proportion of total equity brokerage commission allocated to soft dollars has decreased one-third between 2005 to 2007 (from 11% to 7%)[13]. While there are no indications about longer-term trends, the survey found that the surveyed institutions expect that proportion of soft dollar commissions to remain constant over the next year.

Unfortunately, research by firms such as Greenwich does not address the reasons why firms have changed their use of soft dollars. However, there are a number of theories that may help us understand how competitive dynamics affect the incentives for advisers to reduce their use of client brokerage commissions as payment for research services and order execution services.

While some institutions have ended the practice of using soft dollars, that may only be an option for large portfolio management firms. For others, it may be prohibitively costly to develop in-house research capabilities. The Greenwich Associates research found a decrease in the trend of buy-side firms hiring internal research staff[14] but that may not necessarily result in a change in the use of soft dollars.

Research can be purchased with client brokerage commissions or with hard-dollars. A decrease in the use of soft dollars would need to be covered out of existing management fees or an increase in those fees. Given that management fees are one of the key dimensions upon which advisers compete, there could be reluctance to raise those fees or to reduce current profit margins. This could limit the incentive for advisers to reduce their purchases of client brokerage commission funded research.

Alternatively, increased transparency regarding the use of brokerage commissions to purchase services other than pure order execution would allow investors to incorporate that information into their purchasing decisions. This may, in turn, reinforce the incentives for investment advisers to reduce the use of client brokerage commissions to purchase research services and order execution services.

What is the current regulatory environment?

While Ontario currently has a policy[15] and Québec a rule[16] that provide guidelines regarding brokerage commission arrangements, neither has been recently updated. As a result, they have not kept in step with the requirements and guidance in the U.K. and the U.S.

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[13] Greenwich, 2007, pg 5.
[14] Greenwich, 2007, pg 4.
[15] OSC Policy 1.9 *Use by Dealers of Brokerage Commission as Payment of Goods and Services other than Order Execution Services.*
[16] Policy Statement Q-20 *Use by Dealers of Brokerage Commission as Payment of Goods and Services other than Order Execution Services* (which became a rule in June 2003).

Across the CSA jurisdictions there are no harmonized rules for the use of client brokerage commissions or disclosing those arrangements. There are also inconsistencies between the disclosure of brokerage commission practices for mutual funds and other managed investments.

Regulatory Objective

Members of the CSA believe there is a need to address the potentially adverse effects of this information asymmetry by improving access to information about the use of brokerage commissions and reducing the potential for advisers to, either inadvertently or by design, use the practice for their own benefit and not their clients'.

Four options

There are four options for addressing the use of brokerage commissions as payment for non-execution services:

1. Maintain the status quo;
2. Update the current guidance;
3. Limit the use of client brokerage commissions to order execution; and
4. Reformulate the current requirements into a National Instrument.

1. Maintain the status quo

Ontario would continue to maintain its policy, and Québec its policy statement, on the use of client brokerage commissions. Other jurisdictions would continue to look to those for guidance.

This option would not involve additional compliance costs but there would be a continuing lack of transparency. Investors would remain unable to effectively monitor their adviser's use of brokerage commissions to pay for goods and services other than order execution.

Canada would fall further out of step with the requirements and guidance in the U.K., the U.S.A. and other jurisdictions. This could become a competitive disadvantage for Canada's capital markets if other jurisdictions are perceived to have tighter controls on the use of brokerage commissions. Canadian investment managers may become less attractive to international investors.

2. Update current guidance

Updating and clarifying the provided guidance under the current Ontario policy and Québec rule would provide more certainty to advisers and dealers regarding permitted goods and services. For those advisers and dealers that comply with the revised Ontario policy and Québec rule, the costs would be similar to those associated with reformulating the existing policy and rule into a National Instrument (see below). Advisers would need to review current policies and procedures and develop appropriate disclosure for clients about how their brokerage commissions are used.

There are no guarantees that other CSA jurisdictions would adopt the revised requirements and so increased harmonisation across the CSA may not be achieved. As with the current Ontario policy, the specific elements in the policy would not be enforceable and there would be no guarantee that all advisers would follow the provisions of the policy. As a result, not all investors would benefit from higher quality disclosure and regulators could continue to see many of the same issues currently found during compliance reviews.

Consistency with applicable U.K. and U.S. requirements and guidance will help protect the competitiveness of Canada's capital markets, even if other CSA jurisdictions do not follow suit.

3. Limit the use of client brokerage commissions to order execution

A ban would prohibit dealers and advisers from using brokerage commissions to pay for anything other than pure order execution. Goods and services currently paid for using client brokerage commissions would have to be paid for directly from an adviser's management fee.

Investors

Banning the use of brokerage commissions to pay for anything other than pure order execution eliminates the potential for advisers to over-consume research or execution services. Although, it may also increase advisers' costs which may put upward pressure on management fees.

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

Research costs would have to be recognized as a management expense. Advisers may be reluctant to reduce their margins by using management fees to purchase research. Under-consumption of research could result in sub-optimal decisions for clients.

Third-party service providers

The research by Greenwich Associates[17] found that over 60% of Canadian investment managers purchase third-party research via client brokerage commission arrangements. Only 27% of firms purchased independent research with hard dollars. If advisers are required to purchase independent research out of their management fee, the current levels of consumption may decrease.

Decreased demand for their services could lead to some research providers exiting the market. There would be decreased competition between independent research providers and possibly higher costs.

If advisers pay for non-execution goods and services directly, they will ensure that the goods and services purchased are providing value. Of the investment managers

[17] Greenwich Associates, 2005, pg 5.

Greenwich surveyed in 2005, approximately one quarter purchased independent research using hard dollars[18]. Clearly, advisers see more value in independent research than in its sell-side funded equivalent and prohibiting client brokerage commission arrangements may then lead advisers to substitute independent for sell-side funded research.

Advisers
To the extent there are economies of scope in bundling order execution with other goods and services, banning the practice could result in increased costs to acquire the individual services.

Prohibiting such payments could have a disproportionate impact on smaller advisers who are more reliant on client brokerage commission funded research[19].

Increased costs may also create a barrier to entry for new advisers and may ultimately decrease competition among advisers, thereby reducing choice for investors. Decreased competition in the investment management market could also result in higher management fees.

Canada's competitive position
As previously discussed, a lack of consistency with comparable regulation in other jurisdictions can harm the competitiveness of Canada's markets. Advisers in both the U.S. and the U.K. are permitted to use client brokerage commissions to purchase order execution and research services. Prohibiting the practice in Canada could result in a competitive disadvantage for Canada's securities industry.

4. Reformulate requirements into a National Instrument

The Proposed Instrument addresses concerns about the use of client brokerage commissions by applying a uniform standard to all participating provinces and territories. Participants would be given improved guidance regarding acceptable uses of client brokerage commissions and would be required to provide disclosure to clients about such practices.

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

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[18] Ibid, pg 4.
[19] Greenwich Associates, Statistical Supplement, June 2005, pg 12.

Based on research from other jurisdictions[20], we estimate it would take approximately eight days of effort for Canadian dealers and advisers to review their use of client brokerage commissions in light of the Proposed Instrument. This would result in an estimated one-time cost of about $3 million. Table 1 below shows the breakdown of this cost.

[20] OXERA, 2003, page 18. Although there are differences between the proposed instrument and the FSA's proposal, we view this to be a good estimate of the average effort required to review existing brokerage commission arrangements.

Table 1	
Average salary of compliance officer	$77,000[21]
Estimated effort	6 days
Average salary of legal counsel	$124,000[22]
Estimated effort	1 day
Average senior management salary	$110,000
Estimated effort	1 day
Estimated number of affected firms (dealers and advisers)[23]	1,139
Estimated cost per firm	$2,800
Estimated industry cost ($2,800 * 1,139 firms)	$3.2 million

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

The current Ontario and Québec requirements state that, upon request, advisers should provide to clients the names of research providers from whom research was acquired with brokerage commissions in the last fiscal year and a summary of those goods and services. The Proposed Instrument requires some general annual disclosure (similar to that currently set out in OSC Policy 1.9 and AMF Policy Statement Q-20), but adds the following components:

- a description of the process used when selecting dealers and whether goods and services in addition to order execution are a factor;
- procedures for ensuring that clients that paid for order execution services and research services received reasonable benefit from their use;
- the methods used to assess the overall reasonableness of the amount of brokerage commissions paid relative to the benefits received;
- total brokerage commissions paid by the client during the period reported upon; and
- aggregate brokerage commissions paid during the period and a reasonable estimate of the portion of those commissions that were paid for goods and services other than order execution.

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[21] The estimates for compliance officer and management salaries are based upon discussions with human resources consultants familiar with the employment market for compliance officials.
[22] This is based upon estimates of salaries paid to experienced legal professionals in the regulatory community.
[23] We have assumed that all the 199 dealers and 940 adviser firms have arrangements to use client brokerage commission to purchase order execution services and research services. We expect this to be a high-end estimate of industry costs as not all firms will have such arrangements.

The revised proposal contains considerably less quantitative disclosure than was originally proposed. The cost of developing the disclosure would vary depending on the complexity of the adviser's operations. However, the new disclosure proposal does not require any new information be gathered by advisers and dealers. Also, most of the effort is required upfront, with only limited updating needed each year. Therefore, we do not expect the cost of the proposed disclosure to be significant.

Investors
Investors would have access to more information about their adviser's use of client brokerage commissions and the extent to which they are used to purchase goods and services. The increased transparency would allow investors to better compare advisers' services and so increases the competitive pressures on advisers. However, they may not have sufficient knowledge to determine if the purchased goods and services generated value and improved investment returns.

Improved clarity for dealers and advisers about the goods and services that can be acquired with brokerage commissions should reduce over-consumption of goods and services that do not sufficiently benefit clients. Investors would benefit from reduced trading costs.

Third-party service providers
The Proposed Instrument restricts some services that were not explicitly excluded under the current Ontario policy or Québec rule. This should further reduce any over-consumption of goods and services. If these services did not add value, advisers would likely discontinue their use as opposed to paying for them out of management fees. According to the Greenwich Associates research, the decreased demand is not likely to threaten the viability of those businesses providing the now prohibited services[24].

Client brokerage commissions could still be used to acquire independent research, helping to ensure that its providers are able to compete with dealer-produced research.

Advisers
The Proposed Instrument provides increased guidance regarding approved uses for client brokerage commissions. The resulting increased clarity for advisers could reduce the over-consumption of goods and services that are paid for with brokerage commissions.

The Proposed Instrument would have the full force of law. The threat of regulatory sanction would increase the incentives for advisers to regulate their own behaviour and reduces the risk of non-compliance. The rule would apply in all CSA jurisdictions, which would eliminate any potential competitive distortions that result from having different requirements in different jurisdictions.

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[24] As examples, about 27% of respondents use soft dollar credits to pay for news subscriptions and less than 10% use soft dollar credits to pay for transaction cost analysis (Greenwich Associates, 2005, pg 4).

Canada's Competitive Position
The risk of competitive distortions within the Canadian market would be reduced if the Proposed Instrument applied across the CSA. If advisers in one CSA jurisdiction were permitted to purchase a good or service using client brokerage commissions, advisers in all jurisdictions would be able to do so.

The Canadian capital market will maintain its competitive position relative to the U.S. and U.K. markets. The revised proposal takes further steps to increase harmonisation with the SEC interpretation. This will reduce compliance costs for advisers and dealers and maintain their ability to compete with U.S. based firms.

Summary

Based on this analysis, it is clear that the status quo offers little in the way of benefits and does not sufficiently protect investors. At the other extreme, prohibiting the use of client brokerage commission as payment for execution services and research services could put Canada at a competitive disadvantage and threaten the viability of Canadian independent research providers.

Updating the current requirements decreases uncertainty for dealers and advisers and improves their clients' ability to monitor the use of their brokerage commissions. We expect dealers and advisers to incur a one-time cost of approximately $3 million, or $2,800 per firm, when reviewing their current brokerage commission practices and arrangements. The additional costs of providing more detailed disclosure to clients are not expected to be significant. In comparison, the median 2006 revenue for adviser firms registered as an investment counsel and portfolio manager in Ontario was $879,000[25].

However, the option of modifying the existing requirements in Ontario and Québec would not ensure consistently improved disclosure, harmonization, or enforceability and so does not meet all of our regulatory goals.

The anticipated costs of implementing the Proposed Instrument are the same as those for updating the current requirements, but there are additional benefits to be had from required disclosure and application across the CSA. Our analysis suggests that a National Instrument that provides better guidelines on the use of client brokerage commissions and that mandates disclosure to investors is the best option. It would manage the inherent conflicts of interest without affecting the viability of independent research providers and would provide stakeholders more certainty about the acceptable uses of brokerage commissions. By introducing requirements for consistent and comparable disclosure, the Proposed Instrument will enable investors to make more informed decisions about advisers and to better monitor how their brokerage commissions are spent.

[25] Revenue earned from operations in Ontario. This figure is compiled from internal Ontario Securities Commission information.