Notice

Regulation 23-102 respecting Use of Client Brokerage Commissions

Policy Statement to Regulation 23-102 respecting Use of Client Brokerage Commissions

I. Introduction

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

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

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

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and Autorité des marchés financiers Policy Statement Q-20 of the same name (together, the Existing Provisions), will be rescinded, effective on the date that the Regulation and Policy Statement come into force in Ontario and Québec, respectively.

II. Background

A. First publication for comment

On July 21, 2006, the CSA published for comment a notice, a proposed Regulation (2006 Regulation) and a proposed Policy Statement (together, the 2006 Proposal)[1], relating to the subject matter of the final Regulation.

Forty-three comment letters were received by the CSA in response to the 2006 Proposal. A summary of the comments and our responses were published at the *Bulletin de l'Autorité des marchés financiers* dated January 11, 2008, vol. 5, n° 1.

B. Second publication for comment

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

- Notice of Draft *Regulation 23-102 respecting Use of Client Brokerage Commissions as Payment for Order Execution Services or Research Services* and *Policy Statement to Regulation 23-102 respecting Use of Client Brokerage Commissions as Payment for Order Execution Services or Research Services* (2008 Notice);

- Draft *Regulation 23-102 respecting Use of Client Brokerage Commissions as Payment for Order Execution Services or Research Services* (2008 Regulation); and

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1 Published at the *Bulletin de l'Autorité des marchés financiers* dated July 21, 2006, vol. 3, n° 29 (suppl.).

2 Published at the *Bulletin de l'Autorité des marchés financiers* dated January 11, 2008, vol. 5, n° 1.

- Draft *Policy Statement to Regulation* 23-102 *respecting Use of Client Brokerage Commissions as Payment for Order Execution Services or Research Services* (2008 Policy).

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

III. Substance and Purpose of Regulation and Policy Statement

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

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

The Policy Statement gives guidance regarding the types of goods and services that may be obtained, as well as non-permitted goods and services. It also gives guidance on the disclosure that would be considered acceptable to meet the requirements of the Regulation.

IV. Summary of Changes to 2008 Proposal

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

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

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

(i) Temporal standard for order execution goods and services

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

As a result, we have decided to return to the temporal standard for order execution goods and services proposed in the 2006 Regulation to more closely align its starting point with that included in the SEC Release, and to avoid any potential for confusion. More

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

specifically, subsection 3.2(2) of the Policy Statement now refers to the starting point for the temporal standard as being the point after which an investment or trading decision has been made. In addition, we have also amended paragraph (a) of the definition of ‘research goods and services’ under Part 1 of the Regulation to revert back to similar language from the 2006 Regulation. The definition now indicates that research goods and services includes “advice relating to the value of a security or the advisability of effecting a transaction in a security”.

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

B. Application of the Regulation

(i) Application to trades in futures

Some commenters requested clarification regarding the application of the Regulation to trades in futures contracts. We note that the 2008 Regulation proposed to apply to “any trade in securities … where brokerage commissions are charged by a dealer.” Consequently, it was intended to apply to trades in a futures contract to the extent that the futures contract would meet the definition of a security, and brokerage commissions were charged.

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

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

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

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

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

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

(iii) Application to unsolicited goods or services

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

To provide additional clarification, we have amended the guidance in the Policy Statement (now subsection 4.1(5)) to clarify that an adviser that is provided with access to or receives goods or services on an unsolicited basis should consider whether or how usage of those goods or services has affected its obligations under the Regulation as part of its process for assessing compliance with the Regulation. Additional details can be found in subsection 4.1(5) of the Policy Statement.

C. Obligations under the Regulation

(i) Obligations of advisers

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

First, subsection 3.1(1) of the 2008 Regulation has been revised to state that "an adviser must not direct any brokerage transactions involving client brokerage commissions to a dealer in return for the provision of goods or services by the dealer or a third party,…"[4] This change is intended to reflect that the client brokerage commissions are ultimately associated with the brokerage transactions directed by the adviser on behalf of its client or clients. In addition, language has been added to ensure that it is clear that goods and services other than order execution obtained by the adviser, under the Regulation, can be provided by either the dealer or a third party. We also note that the resulting language is consistent with the long-standing language of the Existing Provisions.

Second, paragraph 3.1(2)(a) of the 2008 Regulation, which would have required an adviser to ensure that the order execution goods and services and research goods and services obtained benefit the client or clients, has been revised. The 2008 Policy explained that, in order to benefit a client, the goods or services obtained should be used to assist with investment or trading decisions, or with effecting securities transactions. This expectation is now more clearly reflected in paragraph 3.1(2)(a) of the Regulation which explicitly requires the adviser to ensure that the goods or services are to be used to assist with investment or trading decisions, or with effecting securities transactions, on behalf of the client or clients.

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

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[4] As a result of this drafting change, similar drafting changes were also required elsewhere in the Regulation and Policy Statement to ensure consistency of the language used throughout, including drafting changes to Part 4 of the Regulation regarding disclosure requirements.

(ii) *Obligations of dealers*

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

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

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

D. **Disclosure**

(i) *General*

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

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

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

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

(ii) *Narrative disclosure*

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

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

(iii) Quantitative disclosure

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

- Persisting valuation issues associated with bundled goods and services will likely result in differences in the methodologies used by advisers for purposes of estimating value for disclosure. This will likely affect both the comparability and usefulness of the disclosure to clients.

- To go further than the requirements of the SEC or other international regulators at this time would create difficulties for Canadian advisers conducting business in multiple jurisdictions, particularly for those that contract a foreign sub-adviser subject to lesser disclosure requirements in their home jurisdiction (who may or may not be willing to undertake systems changes to provide the needed information). This could have an impact on costs to Canadian investors, or result in differences in the quality of disclosure.

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

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

E. Transition Period

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

V. Related Instruments

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

VI. Alternatives and Anticipated Costs and Benefits

Alternatives that were considered, and the potential costs and benefits were discussed in the cost-benefit analysis included in the 2008 Proposal published in the Ontario Securities Commission Bulletin.

We continue to believe that a Regulation that governs the practice of directing brokerage transactions involving client brokerage commissions in return for goods and services other than order execution, and that mandates disclosure to investors is the best option. Further, we believe that the net effect of the changes made to the Regulation and

Policy Statement since the 2008 Proposal will reduce the potential costs to dealers and advisers associated with the implementation of the Regulation.

VII. Questions

Please refer any of your questions to any of:

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Appendix A

Implementation or Adoption of the Regulation

The Regulation will be implemented as:

- a rule in each of Alberta, British Columbia, Manitoba, Newfoundland and Labrador, Nova Scotia, New Brunswick, Ontario and Prince Edward Island;

- a regulation in each of Québec, the Northwest Territories, Nunavut and the Yukon Territory; and

- a commission regulation in Saskatchewan.

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

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

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

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

Appendix A

Summary of Comments and Responses on the 2008 Proposal

I. Definitions of Order Execution Goods and Services and Research Goods and Services

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

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

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

- better defines where best execution measurements should be applied, as any party controlling a trade from the time an investment decision has been made can enhance or detract from best execution; and

- is broader and more flexible than that of the SEC, allowing many services that have become essential to the investment process and best execution.

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

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

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

- although the proposed temporal standard is better aligned with the trade order life cycle and broader than the SEC temporal standard, the difference would be of little practical benefit to Canadian advisers that transact in the U.S., and an unlevel playing field may result between those advisers using Canadian brokers relative to those that use both Canadian and U.S. brokers;

- using a temporal standard that is different from that used in the U.S. may increase reporting difficulties, add to the cost of disclosure, pose more challenges in the future as new products evolve, and increase client confusion.

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

Response:

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

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

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

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

B. Eligibility of certain goods and services

(i) Raw market data

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

Response:

We agree that the additional language regarding the use of market data is likely not necessary given the obligation in subsection 3.1(2) of the Regulation for an adviser to ensure that the goods and services are to be used to assist with investment or trading decisions, or with effecting securities transactions on behalf of the client or clients, and the related guidance provided in subsection 4.1(2) of the Policy Statement. In our view, in order for raw market data to provide any assistance in the investment or trading decision-making processes, an adviser would have to at least analyze the data in some manner. We have therefore made amendments to subsection 3.3(2) of the Policy Statement to remove the additional language.

(ii) Error or correcting trades

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

Response:

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

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

(iii) Direct telephone and dedicated connectivity lines

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

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

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

Response:

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

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

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

Response:

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

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

(v) Alternative order execution products and services

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

Response:

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

C. "Mixed-use" items

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

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

II. Application of the Regulation

A. Application to trades in futures

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

> ***Response:***
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> *Section 2.1 of the 2008 Regulation stated that the "Regulation applies to…any trade in securities…where brokerage commissions are charged by a dealer". The Regulation was intended to apply to trades in a futures contract to the extent that the futures contract would meet the definition of a security, and brokerage commissions were charged in connection with the trade (i.e., a commission or similar transaction-based fee has been charged for a trade where the amount paid for the security is clearly separate and identifiable).*
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> *Given that in certain jurisdictions, the definition of "security" does not include futures contracts, changes have therefore been made to Part 1 of the Regulation to clarify this intention, and to reflect the CSA's view that the same conflicts and issues arise, regardless of the type of security involved.*

B. Limitation of regulation to trades where brokerage commissions are charged

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

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

Response:

We have amended the guidance in subsection 2.1(2) of the Policy Statement to add that an adviser that obtains goods and services other than order execution in conjunction with principal trades where an embedded mark-up is charged is subject to its duty to deal fairly, honestly, and in good faith with clients, and its obligation to make reasonable efforts to achieve best execution when acting for clients. As a result, in our view, an adviser should consider the goods and services obtained in relation to its duty to deal fairly, honestly, and in good faith with its clients, and in its evaluation of best execution

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

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

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

C. Application to unsolicited goods and services

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

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

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

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

Response:

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

The guidance in thePolicy Statement has been amended to clarify that an adviser that is provided with access to or receives goods or services on an unsolicited basis should consider whether or how usage of those goods or services has affected its obligations under the Regulation as part of its process for assessing compliance with the Regulation.

For example, if an adviser considers unsolicited goods or services as a factor when selecting dealers or allocating brokerage transactions to dealers, the adviser should include these goods or services when assessing compliance with the obligations of the Regulation, and should include these in its disclosure.

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

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

D. Application to foreign advisers and sub-advisers

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

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

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

Response:

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

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

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

E. Application to foreign dealers

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

Response:

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

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

III. Obligations under the Regulation

A. Obligations of advisers

(i) Allocation of benefits to clients

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

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

Response:

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

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

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

B. Obligations of Dealers

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

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

Response:

The Regulation indicates that dealers must not accept, or forward to a third party, client brokerage commissions, or any portion of those commissions, in return for the provision to an adviser of goods or services by the dealer or a third party, other than order execution goods and services or research goods and services.

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

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

IV. DISCLOSURE

A. Narrative disclosure

(i) General

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

Response:

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

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

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

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

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

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

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

Response:

We continue to believe that clients would find disclosure of the types of goods and services acquired in connection with brokerage transactions involving client brokerage commissions to be useful information. Subsection 5.3(4) of the Policy Statement continues to include guidance that the disclosure of each type of good or service should be sufficient to provide adequate description of the goods or services received (e.g., algorithmic trading software, research reports, trading advice, etc.)

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

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

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

B. Quantitative disclosure

(i) General

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

- the bundled nature of proprietary goods and services, and the differing levels of information that may be provided by willing dealers, will lead to subjectivity and differences in advisers' estimates and estimate methodologies, and will result in disclosure that cannot be compared across advisers, and may be confusing or even meaningless for investors;

- it may not be possible to obtain the necessary information from sub-advisers to meet the disclosure requirements, when those sub-advisers are not required by the laws in their jurisdiction to maintain such information, or the disclosure would likely be inconsistent between advisers as a result of the differing levels of information likely to be received from sub-advisers;

- experience in the U.K. with the IMA Pension Fund Disclosure Code suggests that without a methodology provided for estimating research and execution costs, advisers have adopted varied and inconsistent methodologies – for example, by valuing research and deeming the remainder execution; by valuing execution and deeming the remainder research; or estimating the cost to reproduce the research;

- quantification of the components of bundled commissions will be difficult, and therefore costly;

- the actual cost of trade execution has so many variables that it is practically impossible to individually value them on a per trade basis;

- both advisers and dealers view the costs of trading as relationship pricing where services are often offered as part of an overall package, making value very subjective;

- it would be unworkable for small firms, and extremely difficult for even the larger firms, to accurately allocate commissions;

- new systems would be required to track and value the commission usage, and any differences in disclosure requirements between Canada and the U.S. may add further complications or costs for advisers doing business in both jurisdictions;

- the majority of jurisdictions cited in IOSCO's report *Soft Commission Arrangements for Collective Investment Schemes* issued in November 2007 did not appear to require the quantitative disclosure proposed in the 2008 Regulation;

- many clients do not typically request from their advisers, and are not interested in receiving, the type of information proposed to be disclosed; and

- experience in the U.K. has shown that even the most sophisticated investors are not using the disclosure provided, and the movement in the U.S. is towards refocusing on what questions should be asked rather than prescribing standard industry disclosure.

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

- disclosure of just the total brokerage commissions paid by the client, and an aggregated total of client brokerage commissions paid;

- disclosure of an aggregate percentage of client brokerage commissions associated with the payment made for independent third-party research and other services on a firm-wide basis, or disclosure of a ratio of total firm-wide commission costs to the assets managed, instead of disclosure of the aggregate commissions paid by the firm across all accounts which could result in the disclosure of confidential and proprietary information, and adversely impact an adviser's business;

- disclosure of the total amount of soft dollar expenses in relation to metrics such as total assets under management or total commissions paid;

- disclosure of an investment fund or account's portfolio turnover rate and trading expense ratio, as is currently required for investment funds under Regulation 81-106; and

- quantification of only the third-party goods and services, with payments for independent third-party research goods and services and goods and services being tracked across client accounts individually and across the firm in aggregate.

Response:

Based on the comments received and in light of developments in the U.S., including the proposed amendments to the SEC's Form ADV[1]*, we have decided not to proceed with quantitative disclosure requirements at this time.*

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

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

(ii) 'Reasonable estimate' standard

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

- a 'reasonable estimate' standard may not be feasible, as evidenced by the vast majority of fund companies taking the view that proprietary research cannot be valued for purposes of disclosure under the lower 'ascertainable' standard in Regulation 81-106;

- the standard for investment funds requires disclosure if the adviser can obtain information about costs, and does not require a "guess" as to the amounts to use when otherwise unable to obtain the needed information; and

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

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

One other commenter suggested that if the CSA proposed to maintain the 'reasonable estimate' standard, that guidance would be needed on how this should be estimated given the above-mentioned view of the majority of fund companies that

[1] The SEC proposed amendments to Form ADV on March 3, 2008 under Release No. IA-2711; 34-57419; File No. S7-10-00.

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

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

Response:

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

We note that investment funds should refer to the quantitative disclosure requirements under Regulation 81-106 and the related guidance in Policy Statement 81-106, and to the additional information provided in CSA Staff Notice 81-315, Frequently Asked Questions on Regulation 81-106 respecting Investment Fund Continuous Disclosure.

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

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

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

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

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

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

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

Response:

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

We note that investment funds should refer to the quantitative disclosure requirements under Regulation 81-106 and the related guidance in Policy Statement 81-106, and to the additional information provided in CSA Staff Notice 81-315, Frequently Asked Questions on Regulation 81-106 respecting Investment Fund Continuous Disclosure.

C. Other specific comments relating to disclosure

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

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

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

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

- differences in requirements in other jurisdictions would affect the comparability of disclosure, and may result in disclosures that are more difficult for clients to comprehend;

- clients should receive the disclosure that the jurisdiction they live in requires;

- there could be significant and unproductive disagreement between the CSA and advisers over which foreign disclosure regimes would be considered similar for purposes of the proposed disclosure requirements; and

- it may cause market participants to be incentivized to execute trades in different jurisdictions in order to provide lesser disclosure to clients.

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

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

Response:

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

We note that investment funds should refer to the quantitative disclosure requirements under Regulation 81-106 and the related guidance in Policy Statement 81-106, and to the additional information provided in CSA Staff Notice 81-315, Frequently Asked Questions on Regulation 81-106 respecting Investment Fund Continuous Disclosure.

(ii) Customization of disclosure

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

Response:

As noted earlier, we have decided not to proceed with quantitative disclosure requirements at this time. We have added guidance to subsection 5.3(1) of the Policy Statement to clarify that the information disclosed by an adviser may be client-specific, based on firm-wide information, or based on some other level of customization, so long as the information disclosed relates to those clients to whom the disclosure is directed.

We note that investment funds should refer to the quantitative disclosure requirements under Regulation 81-106 and the related guidance in Policy Statement 81-106, and to the additional information provided in CSA Staff Notice 81-315, Frequently Asked Questions on Regulation 81-106 respecting Investment Fund Continuous Disclosure.

(iii) Initial disclosure

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

Response:

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

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

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

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

- disclosure to the IRC is not necessary if any conflict relating to the use of client brokerage commissions is mitigated by virtue of following the requirements of any final rule;

- Regulation 81-107 does not create different rules based on whether the fund manager is also the trustee, nor does it prescribe what constitutes a conflict of interest, leaving this determination to the adviser/manager;

- a requirement that a determination be made by the manager as to whether there is a conflict of interest matter requiring the disclosure information be provided to the IRC should not be embedded in proposed Regulation 23-102, whose primary purpose is not related to IRCs; and

- if the IRC is expected to assess whether the commissions paid achieve "a fair and reasonable result" – that is, expected to assess an adviser's business judgment – this would be inconsistent with section 5.1 of Regulation 81-107 which indicates that "the CSA do not consider it the role of the IRC to second-guess the investment or business decisions of a manager…".

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

Response:

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

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

(v) Disclosure in the case of a pooled fund

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

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

Response:

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

(vi) Disclosure of sub-adviser commission usage

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

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

Response:

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

We have revised subsection 4.1(1) of the Regulation to clarify that an adviser must provide the required disclosure to a client if any brokerage transactions involving the client brokerage commissions of that client have been or might be directed to a dealer in return for the provision of any good or service by the dealer or a third party, other than order execution. The guidance provided in subsection 5.3(1) of the Policy Statement has also been amended to clarify the expectation that the disclosure required to be made by the adviser under section 4.1 of the Regulation would also reflect information pertaining to the processes, practices, arrangements, types of goods and services, etc., associated with brokerage transactions involving client brokerage commissions that have been or might be directed to dealers by its sub-advisers in return for the provision of any goods and services other than order execution.

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

V. TRANSITION PERIOD

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

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

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

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

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

- systems would need to be changed or implemented in order to meet the proposed quantitative disclosure requirements;

- a full reporting cycle would have to pass in order to collect the data required to be disclosed; and

- the disclosure requirements in the U.S. have not yet been finalized, and the proposed transition period did not allow for consideration of the impact of any difference in disclosure requirements.

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

Response:

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

B. Effect of transition period

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

Response:

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

C. Status of Existing Policies

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

Response:

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

VI. OTHER COMMENTS / REQUESTS FOR CLARIFICATION

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

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

Response:

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

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

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

Response:

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

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

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

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

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

Response:

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

D. ***Costs***

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

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

Response:

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

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

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

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

E. Harmonization across CSA

One commenter expressed disappointment that it appeared possible that advisors might be subject to different sets of rules within Canada if the British Columbia Securities Commission did not support the implementation of a Regulation, particularly when the purpose of the policy review was to harmonize requirements with those in foreign jurisdictions such as the U.S. and U.K. This commenter added that such lack of consistency among Canadian regulators is confusing to market participants and contributes to a weakening of perception of Canada's capital markets.

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

Canada, but also in the U.S. and U.K., demonstrate completely the need for clearly defined rules and regulatory guidance.

Response:
The Regulation applies in each jurisdiction.

List of commenters

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