The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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Canadian Securities Regulators Re-Propose Soft Dollar Regulations

[22173]

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TO: EQUITY MARKETS ADVISORY COMMITTEE No. 4-08
INTERNATIONAL COMMITTEE No. 6-08
INVESTMENT ADVISERS COMMITTEE No. 2-08
SEC RULES COMMITTEE No. 9-08 RE: CANADIAN SECURITIES REGULATORS RE- PROPOSE SOFT DOLLAR REGULATIONS

The Canadian Securities Administrators (CSA) have proposed for comment revised regulations (the "Proposal") on the use of soft dollars by advisers and registered dealers. [1] CSA has revised its proposal from 2006 (the "2006 Proposal") in response to comments that it received. [2] In the Proposal, CSA clarifies the broad characteristics of the goods and services that may be obtained by advisers with client brokerage commissions as well as the adviser's disclosure obligations in relation to the use of client brokerage commissions. Comments on the Proposal are due by April 9, 2008.

Framework of the Revised Proposal

Under the CSA Proposal, the adviser is restricted from entering into any arrangement to use client brokerage commissions for purposes other than as payment for "order execution services" or "research services" and must ensure that:

a. the goods or services benefit the adviser's client(s); and
b. a good faith determination has been made that the amount of client brokerage commissions paid is reasonable in relation to the value of the services received. [3]

As a result of comments, CSA has narrowed the application of the Proposal. The Proposal is limited to any trade in securities for an investment fund or other account over which an adviser exercises discretion on behalf of third party beneficiaries where brokerage commissions are charged by a dealer. The term "client brokerage commission" includes any commission or similar transaction-based fee charged for a trade where the amount paid for the security is clearly separate and identifiable (e.g., the security is exchange traded or there is some other independent pricing mechanism that enables the adviser to accurately and objectively determine the amount of the commission). The limitation to trades for which a brokerage commission is charged has been included to address

difficulties that would arise for transactions where a mark-up is charged. Advisers that obtain goods and services other than order execution in conjunction with such trades (e.g., fixed income securities traded in the over-the-counter market) remain subject to general fiduciary obligations but will not be able to rely on the Proposal to demonstrate compliance with those obligations.

To benefit a client, the goods and services should be used in a manner that provides "appropriate assistance" to the adviser in making investment decisions or effecting securities transactions. Advisers should be able to demonstrate how the goods and services paid for with client brokerage are used to provide appropriate assistance. In contrast to the 2006 Proposal, the focus has been shifted to the use of the goods and services. Specific order execution services or research services may benefit more than one client, however the adviser should have adequate policies and procedures to ensure that all clients whose commissions were used as payment for the services have received fair and reasonable benefit from such usage. The adviser must ensure that a good faith determination has been made that the amount of brokerage commissions paid is reasonable in relation to the value of the order execution services or research services used and received. This determination can be made either with respect to a particular transaction or the adviser's overall responsibilities for client accounts.

The Proposal would apply equally to registered advisers and to registered dealers that perform advisory functions but are exempt from registration as advisers. The Proposal would permit commissions to be used for payments to third parties for order execution services or research services that are provided to the adviser and were based upon the instructions of the adviser.

Permissible Uses of Commission Dollars – "Order Execution Services" and "Research Services"

In response to comments on the 2006 Proposal, CSA made revisions to the temporal standard for order execution services and the definition and characteristics of research services, including guidance on the eligibility of specific services.

Order Execution Services. Permissible "order execution services" are defined as order execution ("the entry, handling, or facilitation of an order whether by a dealer or by an adviser through direct market access") and other goods and services directly related to order execution. While there were no changes to the definition of order execution services, the temporal standard was modified. The proposed temporal standard for order execution services would generally include goods and services provided or used between the point at which an adviser makes an investment decision (i.e., the decision to buy or sell a security) and the point at which the resulting securities transaction is concluded. CSA understands that this may be different from the standard of the U.S. Securities and Exchange Commission but does not believe the difference should cause any issue on eligibility of particular goods or services rather only the categorization of the service may differ between the two jurisdictions as either order execution service or research service.

Research Services. CSA amended the definition of "research services" to move from a focus on the characteristics of research to a focus on the use of the research. "Research services" are defined as:

a. advice relating to the value of securities or the advisability of buying, selling or

holding securities;
b. analyses or reports concerning securities, portfolio strategy, issuers, industries or economic or political factors or trends; and
c. databases and software to the extent they are designed mainly to support the services in (a) or (b).

To be eligible, research services generally should reflect the expression of reasoning or knowledge and be related to the subject matter referred to in the definition (e.g., securities, portfolio strategy). Additionally, a general characteristic of research services is that, in order to link these to order execution, the services should be provided or used before an adviser makes an investment decision.

Eligibility of Specific Services. The CSA also examined the eligibility of specific services and provides examples of both eligible and ineligible services. Traditional research reports or publications marketed to a narrow audience as well as seminars or conferences (i.e., fees and not incidental expenses such as travel or accommodation) would generally be considered research services. Databases and software that could be considered eligible as research services include quantitative analytical software and market data from feeds or databases that have been or will be analyzed and manipulated to arrive at meaningful conclusions. Also, order management systems may be an eligible research service or order execution service to the extent that they provide research or assist with the research process or help arrange or effect a securities transaction. Order execution services may include algorithmic trading software and market data to the extent they assist in the execution of orders as well as 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. Custody, clearing and settlement services that are directly related to an executed order that generated commissions also may be eligible order execution services.

Certain goods or services are identified as ineligible by the CSA because the services or goods are not sufficiently linked to the securities transaction that generated the commission. For example, CSA generally believes goods and services related to the operation of an adviser's business, rather than services to a client, are ineligible. Examples of ineligible goods or services include office furniture and equipment (e.g., computer hardware, telephone or data communication lines), trading surveillance or compliance systems, portfolio valuation and performance measurement systems or computer software used for administrative functions. In addition, the CSA believes that mass-marketed publications, or publications marketed toward a broad, public audience, are more like overhead for an adviser's business and should generally be paid from an adviser's own funds.

Mixed-Use Services. Mixed-use services are those goods and services that contain some elements that may meet the definitions of order execution services or research services and other elements that either do not meet the definitions or that would not otherwise be eligible under the Proposal. When mixed-used items are obtained by an adviser with client brokerage commissions, the adviser should make a reasonable allocation of the commissions paid according to the use of the goods and services. For example, with respect to mixed-use services such as certain order management systems, an adviser may use client commissions to pay for the portion of the system used for the order execution service but should use their own funds to pay for portions of the system used for compliance, accounting or recordkeeping. For purposes of making a reasonable allocation, an adviser should make a good faith estimate supported by a fact-based analysis. Advisers are expected to keep adequate records to support the allocations.

On proxy voting services, the CSA agreed that such services could be viewed as mixed-use goods and services depending on both their form and content. For example, proxy services that provide information on corporate events such as mergers may include services that could be considered research services; however, proxy services also may include functions that would not be considered research services such as administrative functions of receiving, voting and returning ballots. The CSA believes that it would be difficult to support a claim that using the research services of a proxy service to assist with the administrative functions of voting proxies, including assistance with decisions on how to vote the proxies, provides appropriate assistance in making investment decisions for clients. Therefore, advisers that do determine that certain proxy services meet the definition of research services must ensure that the services are used to benefit clients by providing appropriate assistance in making investment decisions for clients

Required Disclosure

While the CSA received numerous comments concerning the disclosure requirements described in the 2006 Proposal, the CSA maintains its position that additional disclosure relating to the use of client brokerage commissions is necessary in order to increase transparency for clients and accountability for advisers. The CSA adopted some revisions to its 2006 Proposal.

Under the Proposal, advisers would be required to make initial and thereafter, at least annually, disclosure of:

a. the process for, and factors considered in, selecting dealers to effect securities transactions, including whether receiving goods and services in addition to order execution is a
factor, and whether and how the process may differ for dealers that are affiliated entities;
b. the nature of arrangements entered into relating to the use of client brokerage commissions as payment for order execution services or research services;
c. the names of the dealers and third parties that provided goods and services other than order execution under those arrangements and the types of goods and services provided, separately identifying each affiliated entity and the types of goods and services provided by each such affiliated entity;
d. the procedures for ensuring that, over time, all clients whose brokerage commissions are used as payment for these goods and services have received reasonable benefit from such usage;
e. the methods by which the overall reasonableness of the amount of client brokerage commission paid to dealers in relation to the order execution services or research services received is determined;
f. the total client brokerage commissions paid by the client during the period reported upon; and
g. on an aggregated basis, where the level of aggregation has been determined by the adviser, [4] the total client brokerage commissions paid during the period, along with the adviser's reasonable estimate of the portion of those commissions that represents the amount paid or accumulated to pay for goods and services other than order execution during that period.

The requirements relating to the disclosure of the use of client brokerage commissions would include the use of those commissions by sub-advisers. CSA believes that the scope

of quantitative disclosure is consistent with the level of disclosure currently required to be made by investment funds except that the Proposal requires the adviser to make a reasonable estimate of the amounts paid or accumulated to pay for goods or services other than order execution.

The recipient of the disclosure should typically be the party with whom the contractual arrangement to provide advisory services exists. In the case of a fund, the client would typically be the fund unless the adviser is also the trustee and/or manager of the fund (or an affiliate of the trustee or manager of the fund) in which case the adviser should consider whether it would be more appropriate to deliver the disclosure to the Independent Review Committee.

Specific Requests for Comment

The Proposal lists the following four specific questions for comment:

Question 1:

What difficulties might be caused by a temporal standard for order execution 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?

Question 2:

What difficulties might be encountered by requiring the estimate of the aggregate 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 services and order execution services?

Question 3:

As order execution services and research services are increasingly offered in a cross-border environment, should the Proposal 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 Proposal? 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?

Question 4:

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?

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If you have any questions or comments on the Proposal, please contact Susan Olson at (202) 326-5813 or solson@ici.org.

Susan Olson
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endnotes

[1] Notice of Proposed NI 23-102 Use of Client Brokerage Commissions as Payment for Order Execution Services or Research Services and Companion Policy 23-102CP (January 11, 2008) available at http://65.110.175.197/Regulation/Rulemaking/Current/Part2/rule_20080111_23-102_rfc-proposed.pdf.

[2] See Notice of Proposed NI 23-102 Use of Client Brokerage Commissions as Payment for Order Execution Services or Research (July 21, 2006) available at http://65.110.175.197/Regulation/Rulemaking/Current/Part2/rule_20060721_23-102_pro-softdollar.pdf.

[3] Registered dealers may only charge and accept brokerage commissions for order execution services or research services. Further, the dealer may forward to a third party, on instructions of an adviser, any portion of those commissions to pay for order execution services or research services provided to the adviser by that third party.

[4] Advisers are expected to consider the appropriate level of aggregation needed to inform the client. For example, for advisers only offering privately managed accounts, aggregation at a firm wide level may be appropriate. For advisers managing a variety of accounts, such as mutual funds and private accounts, disclosure that aggregates by account type may be appropriate.