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Canadian Securities Regulators Propose New Soft Dollar Regulations; Conference Call Scheduled August 15

©2006 Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice. [20233] August 3, 2006 TO: EQUITY MARKETS ADVISORY COMMITTEE No. 15-06 INTERNATIONAL COMMITTEE No. 21-06 INVESTMENT ADVISERS COMMITTEE No. 5-06 SEC RULES COMMITTEE No. 35-06 RE: CANADIAN SECURITIES REGULATORS PROPOSE NEW SOFT DOLLAR REGULATIONS; CONFERENCE CALL SCHEDULED AUGUST 15 The Canadian Securities Administrators (CSA) recently proposed for comment new regulations (the "Proposal") on the use of soft dollars by advisers and registered dealers.¹ The Proposal would establish definitions of permissible "order execution services" and "research" and would prescribe soft-dollar disclosure requirements. The term "soft dollars" as used in the Proposal applies to both proprietary bundled brokerage and third-party arrangements. The Proposal is intended to provide investors with more information about their adviser's use of soft dollars and clarify and harmonize soft-dollar rules across Canada while taking international developments into account.² The CSA believes that its Proposal is largely consistent with the approach taken by the US Securities and Exchange Commission (SEC) and the UK Financial Services Authority (FSA) in their recent rules and guidance on client commission arrangements. Comments on the Proposal are due by October 19, 2006. The Institute will hold a conference call to discuss the Proposal on Tuesday, August 15 at 2:00 p.m. Eastern time. The number for the call is 888.316.9406 or +1 210.234.0006, and the passcode is 16570. Please contact Ruth Tadesse at rtadesse@ici.org or 202.326.5836 to let us know if you plan to join the call. If you have comments but are unable to join the call, please provide your comments to Glen Guymon at guymon@ici.org or 202.326.5837. ¹ See Notice of Proposed NI 23-102, Use of Client Brokerage Commissions as Payment for Order Execution Services or Research ("Soft Dollar" Arrangements), dated July 21, 2006. A copy of the proposed regulations is available here or at http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part2/rule_20060721_23-102_pro-softdollar.pdf. ² The CSA is a forum for the 13 securities regulators of Canada's provinces and territories to coordinate and harmonize regulation of the Canadian capital markets. Canada does not have a national securities regulator. The proposed regulations are in the form of a proposed National Instrument and Companion Policy that would be adopted in each of the jurisdictions represented by the CSA. ² Framework of the Proposal The CSA Proposal would require an adviser that uses client brokerage commissions as payment for "order execution services" or "research" to ensure that "(a) the order execution services or research benefit the adviser's client(s); (b) the research received adds value to investment

or trading decisions; and (c) the amount of brokerage commissions paid by its client(s) for order execution services or research is reasonable in relation to the value of the order execution services or research received.” Advisers would be required to have policies and procedures to ensure that goods and services received are fairly and reasonably allocated so that there is a connection between the clients whose brokerage commissions were used as payment for the goods and services and the benefits received. Registered dealers would be required to ensure that “commissions received from advisers on brokerage transactions are only used as payment for goods and services that meet the definition of order execution services or research.” The CSA Proposal would apply to all transactions where “brokerage commissions” are charged by a dealer. The definition of “brokerage commissions” is broader than that used by the SEC or FSA, and would apply to trades executed on an agency or principal basis, so long as brokerage commissions are charged. The Proposal also contemplates the inclusion of transactions done on a net basis, and requests comment on how the “dollar amount for services in addition to order execution” could be calculated. 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 to allow flexibility and promote the use of independent research.

Permissible Uses of Commission Dollars

Permissible “order execution services” are defined as order execution (“the entry, handling, or facilitation of an order by a dealer”) and other goods and services essential to the arranging and conclusion of the securities transactions that generated the commissions. There would be a temporal limitation, generally bounded by the time an adviser makes an investment or trading decision and the point at which the securities transaction is concluded. Permissible “order execution services” would include custody, clearing, and settlement services directly related to an executed order, algorithmic trading software, and raw market data to the extent it assists in order execution. The CSA requests comment on the eligibility of order management systems and whether post-trade analytics should be treated as order execution services. “Research” is defined as advice, analysis, or reports that include original thought and the expression of reasoning or knowledge. Research would have to be information that is used to make an investment decision. Raw market data, without additional analysis or manipulation, would not be considered research (in line with the FSA position, but differing from the SEC position). Post-trade analytics could, in some circumstances, be classified as research. The CSA is requesting comment on the use of commissions to pay for proxy-voting services. Goods and services would not qualify as “order execution services” or “research” when they are not sufficiently linked to the securities transactions that generated the commissions. Examples of non-permitted goods and services provided in the Proposal are “office furniture and equipment (including computer hardware), trading surveillance or compliance systems, portfolio valuation and performance measurement services, computer software that assists with administrative functions, legal and accounting services, memberships, mass-marketed or publicly-available information or publications, seminars, marketing services, and services provided by the adviser’s personnel (e.g. payment of salaries, including those of research staff).” For so-called “mixed-use” goods and services that contain some permitted and some non-permitted items, the Proposal would require the adviser to make a “reasonable allocation of the amounts paid according to their use,” and “keep adequate books and records concerning these allocations.”

Required Disclosure Advisers would be required to make initial and periodic disclosure to each of their clients of :

1. Any soft dollar arrangements (whether formal or informal), the names of the dealers and third parties that provided goods and services, and an “adequate description” of goods and services provided by each of the dealers and third parties;
2. The total brokerage commissions paid by the adviser on behalf of the client, and on behalf of all clients for comparison purposes, with respect to

each class of securities for which commissions were paid (for example, equity securities, options, and so on); 3. For each number reported under (2) above, a “reasonable estimate” of what percentage of commissions were for execution only, proprietary bundled brokerage, and third party bundled brokerage; and 4. A “reasonable estimate” of the “weighted average brokerage commission per unit of security that corresponds to each of the percentages” reported under (3) above. There is no requirement to “unbundle” proprietary bundled brokerage (such as that required by the FSA approach), but the adviser would be required to maintain for five years certain details regarding each specific good and service paid for with commissions and to make those details available upon request to clients. The form of disclosure is not specified, other than that it should be provided at least annually in conjunction with other initial and periodic disclosure relating to the management and performance of the account or portfolio.

4 Specific Requests for Comment The Proposal lists the following 15 specific requests for comment:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The CSA Proposal also includes, but does not specifically request comment on, a cost-benefit analysis. * * * * If you have any questions or comments on the Proposal that

you would like to discuss before the scheduled call, please contact Glen Guymon at 202.326.5837 or gguymon@ici.org. Glen S. Guymon Assistant Counsel - International Affairs

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