CSA/ACVM Canadian Securities Administrators Autorités canadiennes en valeurs mobilières

Canadian Securities Administrators

Notice of
National Instrument 23-102
Use of Client Brokerage Commissions

and

Companion Policy 23-102CP

I. Introduction

The Canadian Securities Administrators (the CSA or we) have made National Instrument 23-102 – *Use of Client Brokerage Commissions* (Instrument) and Companion Policy 23-102CP (Companion Policy). The Instrument and Companion Policy 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 Instrument and Companion Policy 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 Instrument will come into force on June 30, 2010 in all CSA jurisdictions. The Companion Policy will come into force at the same time. Additional information regarding the implementation or adoption of the Instrument 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and Autorité des marchés financiers Policy Statement Q-20 of the same name (together, the Existing Provisions), will be rescinded, effective on the date that the Instrument and Companion Policy come into force in Ontario and Québec, respectively.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 National Instrument (2006 Instrument) and a proposed Companion Policy (together, the 2006 Proposal)[1], relating to the subject matter of the final Instrument.

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 (2008) 31 OSCB 499.

[1] Published at (2006) 29 OSCB 5923.

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 Proposed National Instrument 23-102 and Companion Policy 23-102CP (2008 Notice);
- Proposed National Instrument 23-102 – *Use of Client Brokerage Commissions as Payment for Order Execution Services or Research Services* (2008 Instrument); and
- Proposed Companion Policy 23-102CP (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 Instrument and Companion Policy

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

The Instrument 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 Instrument also sets out the obligations of registered dealers.

The Companion Policy 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 Instrument.

IV. Summary of Changes to 2008 Proposal

The changes made to the Instrument and Companion Policy since the 2008 Proposal are intended to clarify and simplify the requirements of the Instrument, and respond to comments received.
A summary of the key revisions made to the Instrument and the Companion Policy 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.

[2] Published at (2008) 31 OSCB 489.

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 Instrument to more closely align its starting point with that included in the SEC Release, and to avoid any potential for confusion. More specifically, subsection 3.2(2) of the Companion Policy 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 Instrument to revert back to similar language from the 2006 Instrument. 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 Instrument

(i) Application to trades in futures

Some commenters requested clarification regarding the application of the Instrument to trades in futures contracts. We note that the 2008 Instrument 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 Instrument 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.

[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).

(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 Instrument, would lead to an inconsistent level of disclosure compared to trades that are subject to the Instrument.

We have amended the guidance in subsection 2.1(2) of the Companion Policy 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 Instrument 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 National Instrument 31-103 *Registration Requirements and Exemptions* (NI 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 Instrument should be amended in the future to bring such trading within the scope of the Instrument.

(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 Companion Policy (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 Instrument as part of its process for assessing compliance with the Instrument. Additional details can be found in subsection 4.1(5) of the Companion Policy.

C. Obligations under the Instrument

(i) Obligations of advisers

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

First, subsection 3.1(1) of the 2008 Instrument 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 Instrument, 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 Instrument, 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 Instrument 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 Instrument). 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 Instrument 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 Companion Policy.

(ii) Obligations of dealers

Some commenters to the 2008 Instrument requested clarification regarding the expected level of due diligence to be performed by dealers in meeting their obligations under the Instrument 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 Companion Policy 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.

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

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 Instrument to separate the requirements for initial and periodic disclosure.

We have not, as suggested from certain comments, made changes to Part 4 of the Instrument 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 NI 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 NI 31-103. The guidance provided in section 13.4 of the Companion Policy 31-103CP 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 NI 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 Instrument 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 Instrument. 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 National Instrument 81-106 have been maintained. The reasons for maintaining these requirements include: (i) disclosure under NI 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 NI 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) NI 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 Instrument and Companion Policy are related to, and are intended to replace, the Existing Provisions. The Existing Provisions will be rescinded, effective on the same date that the Instrument and Companion Policy 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 Appendix B of the 2008 Proposal.

We continue to believe that a National Instrument 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 Instrument and Companion Policy since the 2008 Proposal will reduce the potential costs to dealers and advisers associated with the implementation of the Instrument.

VII. Questions

Please refer any of your questions to any of:

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