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Notice
of Proposed National Instrument 23-102 *Use of Client Brokerage Commissions as Payment for Order Execution Services or Research ("Soft Dollar" Arrangements)*

I. INTRODUCTION

We, the Canadian Securities Administrators (CSA), are publishing for comment proposed National Instrument 23-102 *Use of Client Brokerage Commissions as Payment for Order Execution Services or Research ("Soft Dollar" Arrangements)* (Proposed Instrument) and Companion Policy 23-102 CP (Proposed Policy). The comment period will end 90 days from the date of publication.

We seek to adopt the Proposed Instrument as a rule in each of British Columbia, Alberta, Manitoba, Nova Scotia, Ontario and Québec, as a Commission regulation in Saskatchewan and as a policy in each of the other jurisdictions represented by the CSA. The Proposed Policy would be adopted as a policy in each of the jurisdictions represented by the CSA.

II. BACKGROUND

The Current Regime

The current provisions describing the goods and services that may be acquired by advisers from or through dealers with brokerage commissions are Ontario Securities Commission (OSC) Policy 1.9 *Use by Dealers of Brokerage Commissions as Payment for Goods or Services other than Order Execution Services – ("Soft Dollar" Deals)* and the Autorité des marchés financiers (AMF) Policy Statement Q-20[1], of the same name (Existing Provisions). The Existing Provisions, which are virtually identical, specify that the only services acquired by managers that may be paid for with client brokerage commissions are "investment decision-making services" and "order execution services", provided that these services benefit the manager's beneficiaries, and not the manager. The Existing Provisions specify that these services may be provided directly by dealers or by third parties.

Concept Paper 23-402 Best Execution and Soft Dollar Arrangements

On February 4, 2005, staff of the Alberta Securities Commission, AMF, British Columbia Securities Commission, Manitoba Securities Commission and OSC published Concept Paper 23-402 *Best execution and soft dollar arrangements* (Concept Paper). The purpose of the Concept Paper was to set out a number of issues related to best execution and soft dollar arrangements for discussion and to obtain feedback. "Soft dollars" refers to the use by advisers of commission dollars to pay for trading-related goods or services, including incidental advice, research and analytical tools, in addition to paying for trade execution. In

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[1] AMF Policy Statement Q-20 gained the force of a rule in June 2003 through Section 100 of *An Act to amend the Securities Act* (S.Q. 2001, chapter 38).

the Concept Paper, we specified that "soft dollar arrangements" includes both bundled services provided to advisers by dealers and allocations by advisers of part of the commissions paid to dealers to third parties.

An important concern relating to soft dollar arrangements noted in the Concept Paper was that they create potential conflicts of interest. This concern arises because of the incentives that such arrangements may create for advisers to place their interests ahead of their clients, including the incentive to direct trades to dealers for goods and services that benefit the advisers, and not their clients. The Concept Paper also noted that these potential conflicts of interest may obscure the advisers' best execution obligations, as dealers may be selected for the soft dollar arrangements rather than for the quality of trade execution.

Other issues with these arrangements were also noted, for example: an adviser could potentially reduce costs in a poorly performing portfolio by allocating low commission trades to the portfolio but still use research and execution services paid for by other portfolios; where a mark-up is applied, it is difficult to assess whether a client has received best execution; and it is difficult to measure whether best execution is obtained because the commissions that are at the base of the arrangements sometimes include services from dealers that are bundled, and sometimes are for order execution only.

Twenty-eight comment letters were received. These comments were summarized and published on December 16, 2005, in CSA Notice 23-303 *Update concerning Concept Paper 23-402 Best execution and soft dollar arrangements*.

While three respondents thought that soft dollar arrangements were not consistent with best execution, the majority believed they should be permitted. Some indicated that the benefits to such arrangements include the fact that they allow independent research providers to compete with full-service brokerage firms and ensure the availability of what some commenters viewed as more impartial research. Others noted that soft dollar arrangements allow smaller advisory firms to have access to a broader range of research services, and thus better compete with larger advisory firms. Some respondents echoed the concerns that conflicts of interest may arise for advisers that manage multiple client accounts or funds, as they may use one client's or fund's brokerage commissions to pay for services that benefit other clients or funds.

The overall response was that, while we should continue to permit client brokerage commissions to be used as payment for trading-related goods and services in addition to order execution, the Existing Provisions were too broad and subject to too much interpretation. Respondents noted that there should be more clarity and guidance regarding the types of goods and services that might be allowed under soft dollar arrangements. Almost all respondents agreed that additional disclosure was needed to increase accountability and transparency.

International Developments

Other jurisdictions have also focused on the issue of client commission arrangements in the past few years. In the United States, Section 28(e) of the Securities Exchange Act of 1934 (Exchange Act) provides a safe harbor that protects money managers from liability for a breach of fiduciary duty solely on the basis that they paid more than the lowest commission rate in order to receive brokerage and research services provided by a dealer. In order to be eligible for the safe harbor, money managers must determine in good faith that the amount of the commissions was reasonable in relation to the value of the brokerage and research services received, and the goods or services obtained must meet the broad statutory definitions of brokerage and research services provided under Section 28(e)(3). In October 2005, the Securities and Exchange Commission (SEC) published for comment an interpretive release (2005 Proposing Release)[2] to provide additional guidance. In the 2005 Proposing Release, the SEC narrowed its interpretation of the definitions for brokerage and research services, but did not address disclosure requirements regarding client brokerage commission arrangements. The SEC indicated in the 2005 Proposing Release that it would be providing additional guidance on disclosure requirements at some point in the foreseeable future. On July 18, 2006, the SEC published the final interpretive release[3] (2006 Release) that provides guidance on money managers' use of client commissions to pay for brokerage and research services.

In the United Kingdom, the Financial Services Authority (FSA) adopted final rules on July 22, 2005, in conjunction with issuing policy statement PS 05/9.[4] The FSA final rules describe "execution" and "research" products and services eligible for payment via client brokerage commissions, and specify a number of "non-permitted" services that must be acquired using the investment managers' own funds. The policy statement acknowledges that some products and services may be permitted or non-permitted, depending on how they are used by the investment manager. The FSA final rules also establish certain high-level disclosure requirements, and state that the FSA will have regard to the extent to which investment managers adopt disclosure standards developed by industry (such as the standards set out by the Investment Management Association (IMA)).

Both the SEC's and FSA's initiatives were discussed in the Concept Paper. In the comments received, the majority of respondents encouraged us to consider the approaches taken in the U.S. and the U.K., and to continue to monitor developments in these jurisdictions. We have taken into account the SEC and FSA approaches in developing this proposal and believe that this proposal is largely consistent with these approaches.

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[2] Exchange Act Release No. 34-52635 (October 19, 2005).

[3] Exchange Act Release No. 34-54165 (July 18, 2006). In this release, the SEC is also soliciting further comment on client commission arrangements under section 28(e) of the Exchange Act.

[4] U.K. Financial Services Authority, Policy Statement 05/9, Bundled Brokerage and Soft Commission Arrangements: Feedback on CP 05/5 and Final Rules (July 2005) (FSA Final Rules). Note that these rules apply only to equity trades and not to fixed income trades.

III. SUBSTANCE AND PURPOSE OF THE PROPOSED INSTRUMENT AND PROPOSED POLICY

Purpose of the Proposed Instrument and Proposed Policy

There are fundamental existing obligations for a registered dealer or an adviser to act fairly, honestly, and in good faith with their clients. In addition, securities legislation in some jurisdictions requires managers of mutual funds to also exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances.

The Proposed Instrument provides a specific framework for the use of client brokerage commissions by advisers. It clarifies the broad characteristics of the goods and services that may be acquired with these commissions and also prescribes the advisers' disclosure obligations when using brokerage commissions as payment for these goods and services.

The Proposed Policy gives additional guidance regarding the types of goods and services that may be obtained with client brokerage commissions, 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 Proposed Instrument.

Discussion of the Proposed Instrument and Proposed Policy

In this Notice, discussion of the Proposed Instrument and Proposed Policy is divided into the following topics: application of the Proposed Instrument; the framework for client brokerage commission practices; the definitions of order execution services and research; and the disclosure of client brokerage commission practices.

<u>Application of the Proposed Instrument</u>

Section 2.1 of the Proposed Instrument limits the application of the Proposed Instrument to transactions where brokerage commissions have been charged by a dealer. The reference to "brokerage commissions" includes any commission or similar transaction-based fee. This would therefore also include transactions where the commissions are technically zero, but where a fee can be separately broken out.

We have taken the view that the Proposed Instrument can be applied to transactions in all securities, so long as brokerage commissions are charged. We note that the SEC has taken a slightly narrower view in its 2006 Release[5] by indicating that the safe harbor provided under Section 28(e) applies to client commissions on agency transactions and fees on certain riskless principal transactions, and not to fixed-income trades that are not executed on an agency basis, principal trades (except for certain riskless principal trades), or other instruments traded net with no explicit commissions. The FSA, however, has taken an even narrower view. In its Final Rules, it has restricted the application of the rules to shares and certain related instruments (such as options and warrants). It has stated that its Final Rules do not apply to fixed-income investments, but noted that if the same conflicts of interest

[5] In footnote 27 of the 2006 Release.

were found to be inherent in the fixed-income market, the FSA would revisit its position.[6] We specifically request comment on whether the Proposed Instrument should be restricted to transactions where there is an independent pricing mechanism, for example, for transactions in exchange-traded securities.

We have also provided clarification in section 2.1 of the Proposed Policy that the adviser requirements in the Proposed Instrument apply equally to registered advisers and registered dealers that perform advisory functions but are exempt from registration as advisers.

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?**

The Framework for Client Brokerage Commission Practices

The Proposed Instrument establishes the general parameters for: (1) advisers that enter into any arrangements to use brokerage commissions, or any portion thereof, as payment for order execution services or research; and (2) registered dealers that receive commissions as payment for order execution services or research provided to the advisers.

a) Advisers

Section 3.1 of the Proposed Instrument indicates that advisers may not enter into any arrangements to use brokerage commissions, or any portion thereof, as payment for goods and services other than order execution services or research. It also reinforces the overriding requirement that advisers must act in the best interests of their clients by ensuring that: the order execution services or research paid for with client commissions benefit the clients; the research received adds value to investment or trading decisions; and the brokerage commissions paid are reasonable in relation to the value of goods and services received. Section 4.1(1) of the Proposed Policy clarifies that the arrangements that advisers may enter regarding the use of client commissions may be formal or informal, and that informal arrangements would include those relating to the receipt of such goods and services from a dealer offering proprietary, bundled services.

Section 4.1(2) of the Proposed Policy also clarifies that in order to ensure that the order execution services or research paid for with brokerage commissions benefit the client(s), the adviser should have adequate policies and procedures in place to ensure that a reasonable and fair allocation of the goods and services received is made to its client(s). This is

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[6] The FSA's basis for limiting the Final Rules to shares and related investments was discussed in Consultation Paper 05/5 - *Bundled brokerage and soft commission arrangements: proposed rules.*

necessary so that there is a connection between the client(s) whose brokerage commissions were used as payment for goods and services and the benefits received.

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?

b) Registered Dealers

While advisers have the responsibility to act in the best interests of their clients, registered dealers must also 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. A registered dealer's obligations are set out in section 3.2 of the Proposed Instrument.

Subsection 4.2 of the Proposed Policy also indicates that the Proposed Instrument does not restrict a registered dealer from forwarding to a third party, on the instructions of an adviser, any portion of the commissions it has charged on brokerage transactions to pay for order execution services or research provided to the adviser by that third party. We believe such practices should be permitted in order to provide flexibility and promote the use of independent research. Additionally, we agree with commenters to the Concept Paper that there should be no difference in eligibility of these services based on who provided them.[7]

Definitions of order execution services and research

The Proposed Instrument sets out the definitions of order execution services and research. The definitions include a description of the general characteristics of goods and services that qualify as order execution services or research.

The Proposed Policy provides further explanation of the definitions and provides guidance on the types of goods and services that may be paid for with brokerage commissions. A broad range of goods and services may be considered, regardless of form. The Proposed Policy reinforces that an adviser's responsibilities include determining whether a good or service, or a portion thereof, may be paid for with brokerage commissions, and to ensure both that the good or service meets the definition of order execution services or research and that it benefits the client(s).

[7] We noted that the FSA, in its Final Rules, did not place any restrictions on whether the goods and services for which commissions were used as payment are provided by the registered dealer or by a third party. Similarly, in its 2006 Release, the SEC also permits client commissions to be used as payment for goods and services provided by a third-party.

a) Order execution services

Part 1 of the Proposed Instrument defines order execution services to include order execution, as well as goods and services that are directly related to order execution. Subsection 3.2(1) of the Proposed Policy clarifies that, for the purposes of the Instrument, the term “order execution”, as opposed to “order execution services”, means the entry, handling or facilitation of an order by a dealer, but not other tools that are provided to aid in the execution of trades.

Section 3.2 of the Proposed Policy clarifies that goods and services that are directly related to order execution are those that are essential to the arranging and conclusion of the securities transactions that generated the commissions. The Proposed Policy includes a temporal limitation, similar to those adopted by the SEC and FSA, to help describe the goods and services received by an adviser that are integral to the execution process. As a result, such goods and services provided between the point at which an adviser makes an investment or trading decision and the point at which the resulting securities transaction is concluded would generally be considered order execution services. The conclusion of the resulting transaction would occur at the point that settlement is completed. Therefore, order execution services could include custody, clearing and settlement services.

Subsection 3.2(3) of the Proposed Policy provides examples of goods and services that are generally considered to be order execution services including trading advice, algorithmic trading software, and raw market data to the extent it assists in the execution of orders.

We note that there has been some debate in other jurisdictions regarding whether order management systems (OMSs) should be considered order execution services (OMSs may assist with functions such as order entry and routing, messaging, execution tracking, order inquiry, recordkeeping and supervision). In the 2006 Release, the SEC stated that certain functionality provided through OMS may be eligible brokerage or research. The FSA’s position is that these systems may be paid for with client brokerage commissions to the extent they are used for purposes that are directly related to order execution, and that provide benefit to the clients. Given the many different uses of OMSs, we are specifically requesting comment on this issue.

We also noted that the FSA has taken the position that post-trade analytics would not be considered to be order execution services as they are not sufficiently related to the execution of orders on a client’s behalf, and they do not fall within similar temporal limitations. In its 2006 Release, the SEC stated that, to the extent that pre-trade and post-trade analytics are used in the investment decision-making process, they may be obtained with client commissions, and therefore would be treated as mixed-use products. Similarly, we propose to exclude post-trade analytics from goods and services that may be considered order execution services; however, post-trade analytics could be considered to be research to the extent they meet the definition of research, as discussed below.

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?**

b) Research

The Proposed Instrument defines research as advice, analyses or reports and indicates the general subject matter that these goods and services should contain. In Part 3 of the Proposed Instrument, there are also requirements relating to the adviser's responsibility to ensure the research adds value to investment or trading decisions. Section 3.3 of the Proposed Policy provides further clarification.

We propose that, in order to add value to an investment or trading decision, research should include original thought and the expression of reasoning or knowledge. For this reason, information or conclusions that are commonly known or self-evident, that are simply a restatement or repackaging of previously stated information or conclusions, or information and data that have not been analyzed and manipulated in arriving at meaningful conclusions do not contain original thought, and may not reflect the expression of reasoning or knowledge. These would therefore not be considered research that may be paid for with client brokerage commissions. These views are consistent with those expressed by the SEC and FSA in their 2006 Release and Final Rules, respectively.[8] It is our view that to be permitted research, it would also have to be provided before an adviser makes an investment or trading decision, in order to link the research to order execution.

Subsection 3.3(2) of the Proposed Policy includes examples of the goods and services that we would generally consider to be research for the purposes of the Proposed Instrument. One of these items is market data, if it has been analyzed or manipulated to arrive at meaningful conclusions. Therefore, raw market data would not be considered to be research (although it may, in appropriate circumstances, be considered to be order execution

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[8] The definition of research in the Proposed Instrument is similar to the definition in the SEC safe harbor (the FSA interprets research in a similar manner, in its Final Rules, provided it is directly relevant and used to assist in the management of investments on behalf of customers). The guidance provided in the Proposed Policy takes into consideration the interpretations and guidance provided by both the SEC in their 2005 Proposing Release, confirmed in the 2006 Release, and by and the FSA in its Final Rules. Differences in the interpretation of the types of goods and services that may be considered to be research are highlighted in this section.

services) as it has not been analyzed or manipulated and would therefore not contain original thought or the expression of reasoning or knowledge.

We note that the FSA, in its Final Rules, took the position that raw market data that has not been analyzed or manipulated cannot be considered research (the FSA's position that raw market data may be considered for inclusion in order execution services is consistent with our position). The SEC, however, took the view in the 2006 Release that all market data (including raw market data) such as stock quotes, last sale prices and trading volumes, contains aggregations of information on a current basis related to the subject matter identified in Section 28(e), and therefore contains sufficient substantive content to be considered research.

Another item we believe should be considered to be research under the Proposed Instrument is post-trade analytics from prior transactions in securities, if such analytics help inform subsequent investment or trading decisions. Our view is consistent with the FSA and SEC positions that post-trade analytics may, in some circumstances, be classified as research.

Another issue raised by the SEC in their 2005 Proposing Release related to proxy-voting services. Specifically, the SEC asked whether proxy-voting services are being paid for with client commissions. It had previously found that client commissions were being misused as payment for *electronic* proxy-voting services, as advisers had purchased software to administer the proxy-voting function with these commissions.[9] The responses to the 2005 Proposing Release showed that U.S. market participants, while acknowledging that the proxy-voting agent function is an administrative function that must be paid by them with their own funds, considered a portion of the proxy-voting services as a research function[10], eligible to be paid for with client commission. In its 2006 Release, the SEC clarified that proxy-voting services would be eligible to be paid for with client commission to the extent that they are used to make investment decisions. We seek comment regarding the use of client brokerage commissions to pay for proxy-voting services below.

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.?

[9] Based on data from the *Inspection Report on the Soft Dollar Practices, of Broker-Dealers, Investment Advisers and Mutual Funds*, prepared by the SEC's Office of Compliance, Inspections and Examinations, dated September 22, 1998.
[10] See 2006 Release at page 37.

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?

c) Mixed-use goods and services

Section 3.4 of the Proposed Policy provides guidance regarding mixed-use items, which are goods and services that contain some elements that may meet the definitions of order execution services or research, and other elements that either do not meet the definitions or that would not meet the requirements of Part 3 of the Instrument (such as the previously-mentioned OMSs, post-trade analytics, and proxy-voting services). Specifically, it indicates that, where goods and services paid for with brokerage commissions have a mixed use, the adviser should make a reasonable allocation of the amounts paid according to their use, and should keep adequate books and records concerning these allocations. This would help to ensure that the brokerage commissions paid by clients are not used to pay for the components of such items that did not directly benefit them. Furthermore, the portion of a good or service that does not benefit clients should be paid for with the adviser's own funds. This approach is consistent with the SEC's views regarding mixed-use items. We note that the FSA did not specifically address the permissibility of mixed-use goods and services in its Final Rules, but it appears that the FSA's Final Rules do not restrict the use of brokerage commissions to pay for mixed-use goods and services.

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)?

d) Non-permitted goods and services

Section 3.5 of the Proposed Policy provides examples of goods and services that, due to their characteristics and the lack of a clear connection to specific securities transactions, are

not considered order execution services or research for the purposes of the Proposed Instrument. These are goods and services that are primarily related to the operation of an adviser's business.

Included as non-permitted items are seminars, as well as mass-marketed or publicly-available information or publications. Similar to the position reflected in the FSA's Final Rules, we indicate in the Proposed Policy that these items are not sufficiently linked to an adviser's investment or trading decisions, or the execution of orders, to be permissible. In the 2006 Release, however, SEC staff indicated that seminars, if they contain the expression of reasoning or knowledge and relate to the subject matter of Section 28(e), could be permitted as research. With respect to mass-marketed and or publicly available information or publications, SEC staff clarified that certain financial newsletters and trade journals intended to serve the interests of a narrow audience could be research if they relate to the subject matter of Section 28(e), however, they stated that mass-marketed publications will not be eligible to be paid for with client commissions.

Question 9:

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

e) General Considerations

The Proposed Policy provides examples of some of the most commonly encountered goods and services that, in our view, may be considered order execution services or research and those that are non-permitted. However, the examples given are not exhaustive. In the responses received to the Concept Paper, we were provided with other examples of goods that should not be permitted.

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?**

Disclosure of Client Brokerage Commission Practices

Part 4 of the Proposed Instrument sets out the initial and periodic disclosure to be made to clients by advisers that enter into arrangements where brokerage commissions, or any portion thereof, are used as payment for goods and services other than order execution.

The Proposed Instrument requires the disclosure to be provided to each of its clients on an initial basis, and at least annually. Section 5.1 of the Proposed Policy clarifies that the initial disclosure should be made before an adviser starts conducting business with its clients, and that periodic disclosure should be made at least on an annual basis. Section 5.3

of the Proposed Policy also clarifies that the form of disclosure may be determined by the adviser based on the needs of its clients, but that the disclosure should be provided in conjunction with other initial and periodic disclosure relating to the management and performance of the account, portfolio, etc. Some examples are provided.

Question 11:

> **Should the form of disclosure be prescribed? If prescribed, which form would be most appropriate?**

Section 4.1 of the Proposed Instrument also requires the adviser to make adequate disclosure of the following: the arrangements entered into relating to the use of brokerage commissions as payment for order execution services or research, the names of the dealers and third parties that provided these goods and services, and the general types of these goods and services provided by each of the dealers and third parties (for example, algorithmic trading software, research reports, trading advice, etc.).

In addition, certain disclosures should be made relating to the amounts of commissions paid by the adviser during the period reported upon. In subsections 4.1(b) through (d) of the Proposed Instrument, advisers are required to disclose to each client the total brokerage commissions, broken down by security class (for example, equity, options, etc.), that were paid by advisers on behalf of each client and on behalf of all clients, for comparison purposes. Advisers are also required to separate the trades as follows: trades where clients receive only order execution from dealers and no other services; trades where they receive bundled services; and trades where part of the commission paid is directed to third parties. The latter category is further sub-divided into third-party research, other third-party services, and the dealers' portion. The advisers must make reasonable estimates, for each client and for all clients in aggregate, of the brokerage commissions for each one of these categories of trades as a percentage of the total brokerage commissions paid and disclose these percentages to their clients. In addition, advisers are also required to estimate and disclose the weighted average brokerage commission per unit of security corresponding to the commissions underlying each of those percentages. Additional guidance is provided in the Proposed Policy regarding the different categories of order execution identified in the disclosure and the method that should be used for calculating the weighted average.

We are of the view that disclosure of these amounts, percentages and weighted averages would increase transparency regarding the brokerage commissions paid on the clients' behalf by helping them to better assess the uses of brokerage commissions by the advisers. This should also lead to greater accountability on the part of the adviser relating to the use of these commissions. Since one of the main reasons given in support of soft dollar arrangements is that such arrangements facilitate independent research, we are also of the view that the separate disclosure of the amount of commissions forwarded by dealers to third parties for research would be useful information.

To further increase the level of transparency and accountability, in subsection 4.1(2) of the Proposed Instrument, the adviser is required to maintain certain additional details regarding each specific good and service received for which payment was made with brokerage commissions, and to make the details available upon request to its clients. We also believe the adviser should maintain these details relating to activity over the most recent five years.

We are considering whether there should be additional disclosure requirements for trades done on a "net" basis, where the transaction fee paid to the dealer is embedded in the price of the securities (for example, for trades done on a principal basis). We acknowledge the complexities involved in calculating the costs associated with a trade executed on a net basis, as well as the fact that advisers may take different approaches in estimating these costs. We note that in the U.K., the IMA's disclosure requirements in this regard are limited to the disclosure of the percentage of trades executed without explicit commissions, and no further allocation of the implicit costs is made. We are requesting comment on the appropriate disclosure requirements for trades executed on a net basis.

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?**

IV. NO TRANSITION PERIOD

We are not proposing that there be a transition period in light of the fact that the Existing Provisions are in place, and that the Proposed Instrument and Proposed Policy provide

additional guidance. Additionally, there will be a period of time between the adoption of any final instrument and its effective date, during which time advisers may make any needed modifications to policies, practices and arrangements, with the most significant modifications likely relating to the increased disclosure requirements.

V. SPECIFIC REQUESTS FOR COMMENTS

In summary, we specifically request comment on the following issues:

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?

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?

VI. AUTHORITY FOR THE PROPOSED INSTRUMENT

In those jurisdictions in which the Proposed Instrument is to be adopted as a rule or regulation, the securities legislation in each of those jurisdictions provides the securities regulatory authority with rule-making or regulation-making authority in respect of the subject matter of the Proposed Instrument.

In Ontario, the Proposed Instrument is being made under the following provisions of the *Securities Act* (Ontario) (Act):

- Paragraph 2(i) of subsection 143(1) of the Act allows the Commission to make rules in respect of standards of practice and business conduct of registrants in dealing with their customers and clients, and prospective customers and clients.

- Paragraph 2(ii) of subsection 143(1) of the Act allows the Commission to make rules in respect of requirements that are advisable for the prevention or regulation of conflicts of interest.

- Paragraph 7 of subsection 143(1) of the Act allows the Commission to make rules prescribing requirements in respect of the disclosure or furnishing of information to the public or the Commission by registrants.

VII. RELATED INSTRUMENTS

The Proposed Instrument and Proposed Policy are related to the Existing Provisions. The AMF and OSC intend to revoke the Existing Provisions and to replace them with the Proposed Instrument and the Proposed Policy, if and when adopted. The revocation of the Existing Provisions is not intended to take effect until the effective date of the Proposed Instrument.

VIII. ALTERNATIVES CONSIDERED AND ANTICIPATED COSTS AND BENEFITS

The alternatives considered, and the anticipated costs and benefits of implementing the Proposed Instrument, are discussed in the cost-benefit analysis entitled *Cost-Benefit Analysis: Use of Client Brokerage Commissions as Payment for Order Execution Services and Research*. The cost-benefit analysis has been published together with this Notice and is included as Appendix "A".

IX. UNPUBLISHED MATERIALS

In developing the Proposed Instrument, we have not relied on any significant unpublished study, report, or other material.

X. COMMENTS AND QUESTIONS

Interested parties are invited to make written submissions with respect to the Proposed Instrument, Proposed Policy, and the specific questions set out in this notice. Please submit your comments in writing before October 19, 2006.

Submissions should be sent to all securities regulatory authorities listed below in care of the OSC, in duplicate, as indicated below:

British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Securities Commission
Manitoba Securities Commission
Ontario Securities Commission
New Brunswick Securities Commission
Securities Office, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Registrar of Securities, Northwest Territories
Registrar of Securities, Nunavut
Registrar of Securities, Yukon Territory

c/o John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
Suite 1903, Box 55
Toronto, Ontario M5H 3S8
e-mail: jstevenson@osc.gov.on.ca

Submissions should also be addressed to the Autorité des marchés financiers (Québec) as follows:

Madame Anne-Marie Beaudoin
Directrice du secrétariat
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, Tour de la Bourse
Montréal (Québec) H4Z 1G3
Telephone: (514) 940-2199 ext. 2511
Fax: (514) 864-6381
e-mail: consultation-en-cours@lautorite.qc.ca

A diskette containing the submissions should also be submitted. As securities legislation in certain provinces requires a summary of written comments received during the comment period be published, confidentiality of submissions cannot be maintained.

Questions may be referred to:

Cindy Petlock
Ontario Securities Commission
(416) 593-2351

Susan Greenglass
Ontario Securities Commission
(416) 593-8140

Ruxandra Smith
Ontario Securities Commission
(416) 593-2317

Tony Wong
British Columbia Securities Commission
(604) 899-6764

Ashlyn D'Aoust
Alberta Securities Commission
(403) 355-4347

Doug Brown
Manitoba Securities Commission
(204) 945-0605

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(514) 395-0558 x4358

July 21, 2006