CONCEPT PAPER 23-402
BEST EXECUTION AND SOFT DOLLAR ARRANGEMENTS

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Executive Summary

In response to our rapidly changing markets and initiatives in other jurisdictions, we initiated a project to consider "best execution" in the Canadian context. The purpose of this concept paper is to set out a number of issues related to best execution and soft dollar arrangements for discussion and obtain feedback. Based on the feedback received through the consultation process, we will consider the appropriate next steps (if any).

Although in some jurisdictions there are statements setting out what may be considered to be best execution, it is generally acknowledged that it is difficult to determine a single definition (especially one with a bright line test). Best execution has often been equated with obtaining the best price, but has more recently been described as the outcome of a process. For the purposes of this paper, to provide a starting point for the discussion, we set out a proposed description of "best execution" based on the following key elements: price, speed of execution, certainty of execution, and total transaction cost.

One crucial aspect to consider with best execution is the ability to test compliance after the fact. An important factor is whether there are adequate methods for measurement and if they are being appropriately used. In order to ascertain whether best execution has been achieved, it is necessary for firms to review and monitor the quality of trade execution and for such information to be available to regulators. Most market participants agree that measurement is important in assessing best execution, however, there is currently no consensus regarding the appropriate means to do so.

Best execution is mainly the responsibility of the dealer who is handling an order, but all parties involved in a trade have some responsibility. A registered adviser, for example, must determine the needs of its clients and is responsible for setting out specific requirements for each order. In fact, all clients should be clear in providing instructions to their dealer on what their objectives are for each trade. Finally, marketplaces may also have a role in ensuring that best execution is obtained.

There may be different considerations for assessing best execution depending on where a security is trading – is it a Canadian-only, inter-listed or foreign security? – and the structure of the market. Although best execution applies to all transactions regardless of the type of market, there are constraints that are applicable. For example, the lack of transparency in over-the-counter (OTC) markets generally makes it more difficult to assess execution quality. Therefore, given the data constraints with OTC trades, measurement becomes a more complex exercise. On the other hand, readily available data on exchange-traded securities provides clients with the ability to reasonably assess trade executions.

There are also a number of potential barriers to achieving best execution. Soft dollar arrangements (i.e., where advisers use commission dollars to pay for trading-related goods or services) is one area that raises issues about whether best execution is obtained. In some cases, a mark-up may be applied above the commission rate that the client usually pays. If the commission is already a bundled commission and a mark-up is applied on top of that, it is difficult to understand how the ultimate client receives best execution. In addition, measurement becomes more complex with soft dollar arrangements, as it is difficult to compare trading commissions that include a bundle of proprietary services against

commission payments that include a portion to the dealer and a portion to third parties unless dealers are pricing all services separately.

There are a number of potential conflicts associated with soft dollar arrangements, not all of which relate directly to a best execution obligation. Soft dollar issues are dealt with in the section entitled "Potential barriers to achieving and measuring best execution" but may be broader, i.e., an adviser using soft dollar arrangements may also have challenges in meeting its general obligations to its clients. Conflicts arise in any case where there is potential for advisers to put their interests before their clients'. It may be difficult to determine with certainty which services the adviser receives from dealers that are being paid with clients' commissions and whether in all cases the client who pays is the client who gets the benefit of these services.

Directed brokerage (which involves a commitment to place orders with a specific dealer in return for certain services) and commission recapture (which allows institutional investors to track the amount of commission dollars and, in prescribed circumstances, receive back a certain percentage) both raise issues about whether best execution is impeded if incentives to not act in the best interests of clients are created.

Other jurisdictions are currently dealing with issues with respect to best execution and soft dollar arrangements. In the United States, the Securities and Exchange Commission (SEC) has articulated the duty of best execution in several releases. Most recently, the SEC considered soft dollar arrangements and the scope of the safe harbor contained in section 28(e) of the Securities and Exchange Act of 1934. In the United Kingdom, the Financial Services Authority (FSA) published a consultation paper on best execution in October 2002. In April 2003, the FSA published a consultation paper on bundled brokerage and soft commission arrangements and recently published a policy statement with feedback on the paper. The FSA is considering limiting the range of goods and services that fund managers can buy through commissions and requiring fund managers to make enhanced disclosure to their clients about the costs of execution and research. The FSA is looking to industry to provide a framework for the breakdown between the costs of execution and the costs of research. In Australia, the Australian Securities and Investment Commission (ASIC) recently issued a report on soft dollar benefits that describes types of soft dollar benefits, examines how benefits are being disclosed and comments on disclosure practices.

We are seeking comment on all aspects of the concept paper; however, we also raise specific questions for comment.

1. Background

Best execution has been the subject of much debate by regulators, market participants and investors in securities markets around the world. Advances in technology and the rise of alternative trading systems (ATSs) have increased the complexity of fulfilling the duty to obtain best execution of a client order. Although dealers and advisers are subject to various best execution requirements, determining what constitutes "best execution" in practice is a complex issue. What is clear is that there is no single, agreed-upon definition of best execution. To some, it means achieving the best price for a transaction. To others, it is obtaining the most timely execution possible. In the end, whatever definition is used, an important part of ensuring that best execution is obtained is the ability to measure execution quality.

Other jurisdictions have spent considerable effort in addressing issues relating to best execution. The SEC dealt with best execution issues in a number of releases including the order handling rules that are designed to improve the handling of customer limit orders and the rules requiring disclosure of order routing and execution practices. More recently, the SEC has been focused on practices engaged in by both broker-dealers and investment managers that impede best execution such as "soft dollars", commission recapture and directed brokerage. In the United Kingdom, the FSA dealt with best execution in the context of competing marketplaces in a consultation paper published in October 2002. Like the SEC, the FSA has also turned its attention to the impact of other issues that impede best execution and published a consultation paper in April 2003 (CP 176). In May 2004, the FSA published *Bundled Brokerage and Soft Commission Arrangements, Feedback on CP 176,* which set forth its views on limiting the range of goods and services that can be paid for with commissions. The FSA also proposes to increase disclosure regarding the use of commissions.

Both the SEC and the FSA have addressed best execution by first looking at market structure issues and then assessing other issues that impede the achievement of best execution. In Canada, in the absence of multiple, competing marketplaces, market structure has not demanded the same degree of attention. However, with new methods of trading and the continued globalization of the securities markets, we believe that it is necessary to address the concept of best execution in our markets.

This concept paper was initiated to assess whether there is a consistent understanding of best execution in Canada, to seek clarity in defining best execution, to determine which issues currently affect the quality of execution and to ensure there is an appropriate regulatory framework in place to support it. As a first step, OSC staff held informal discussions with a number of market participants to confirm the issues and obtain initial feedback. The comments obtained have been incorporated into this concept paper.

There has been substantial analysis in other jurisdictions, which has helped us in identifying issues. However, as our markets may be distinguished to some degree – especially from the perspective of market fragmentation – it is important that all issues be considered in a Canadian context. The purpose of this concept paper is to generate discussion of these and any related issues that have not been identified and use the feedback received through the consultation process to determine next steps. We are seeking comment on all aspects of

this concept paper; however, we request specific comment on the questions raised throughout.

2. Responsibility for Best Execution

All parties involved in a trade have responsibilities in relation to best execution. It is universally acknowledged that a dealer handling an order for a client has an obligation to seek best execution when executing that order. In addition, a registered adviser[1] has a responsibility to determine and set out instructions for each order (whether given to a dealer verbally or electronically) and to monitor the trade execution. Further, all clients should give clear directions so that the registrant they are dealing with can satisfy its obligation to provide best execution. Finally, marketplaces may also have a role in ensuring that best execution is obtained. Set out below is a brief discussion of these roles.

a) Dealers' obligations

The obligation of a dealer to provide best execution is well established. Securities legislation imposes a fundamental obligation on dealers to deal fairly, honestly and in good faith with its clients. This general duty is set out in common law, and in Québec, in civil law, and has been codified in various instruments[2].

Currently, there are specific requirements in securities legislation and SRO rules dealing with best execution that begin with a general obligation and then focus on price. For example, section 4.2 of National Instrument 23-101 *Trading Rules (*NI 23-101) provides that a dealer acting as agent for a client must make reasonable efforts to ensure that the client receives the best execution price on a purchase or sale of securities. Companion Policy 23-101CP explains further that, in satisfying its fiduciary obligations to its client, a dealer should make reasonable efforts to obtain a lower price on an order to buy or a higher price on an order to sell than is currently available by posting a better bid or offer.

In addition, section 5.1 of the Universal Market Integrity Rules (UMIR) provides that a dealer shall "diligently pursue the execution of each client order on the most advantageous terms for the client as expeditiously as practicable under prevailing market conditions". Section 5.2 sets out a best price obligation and requires a dealer to make "reasonable efforts" to ensure that a client order receives the best price. Further, rule 6310 of the Bourse de Montréal rules deals with best execution and provides that a member must use reasonable care consistent with just and equitable principles of trade, high standards of professional conduct and integrity to obtain the best price for its client.

The Investment Dealers Association of Canada (IDA) reflects the general obligations in By-Law 29, which sets out requirements that specify that all officers and employees of member firms must "observe high standards of ethics and conduct in the transaction of their business" and must "not engage in any business conduct or practice which is unbecoming or detrimental to the public interest".

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[1] Throughout the paper, when we refer to "adviser", we are referring to a registered adviser under securities legislation, which includes investment counsel and portfolio managers, acting as intermediaries between dealers and clients.

[2] See, for example: Ontario Securities Commission Rule 31-505 *Conditions of Registration* (OSC Rule 31-505); ASC Policy 3.1, *Registrants Code of Conduct and Ethical Practices* and subsections 92(3)(c) and (d) of the *Securities Act* (Alberta); Sections 160 and 161 of the *Securities Act* (Québec); Sections 14 and 44(1) of the Securities Rules (BC), section 4.2 of BC Policy 31-601 *Registration Requirements* and sections 50 and 55 of the *Securities Act* (British Columbia); MSC Proposed Local Rule 31-501 *Registration Rule*.

b) Advisers' obligations

In general terms, advisers have a responsibility to act in the best interests of their clients. For example, section 2.1 of OSC Rule 31-505 contains general requirements applicable to registered advisers to deal fairly, honestly and in good faith with their clients.

As part of the process for seeking best execution, advisers often have specific obligations. First, advisers must ensure that the strategies that they determine for trade execution for their clients are appropriate in the circumstances. Second, advisers must allocate trades fairly among client accounts. This is set out in securities legislation in some jurisdictions[3] which requires every investment counsel to maintain standards directed at ensuring fairness in the allocation of investment opportunities among its clients. These requirements also impose an obligation on advisers to monitor trading costs and to ensure that they are minimized without foregoing the necessary services from dealers.

In addition, securities legislation in some jurisdictions requires any person or company responsible for the management of a mutual fund to act honestly, in good faith and in the best interests of the mutual fund and to exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances[4].

There are also Trade Management Guidelines set out by the CFA Institute [formerly the Association for Investment Management and Research (AIMR)] to assist investment management firms in meeting their best execution obligations. The guidelines describe best execution as a process that investment management firms apply to seek to maximize the value of a client's portfolio within the client's stated investment objectives and constraints. According to the guidelines, advisers have a duty to seek the most favourable execution terms reasonably available given the specific circumstances of each trade.

c) Client's role

A client, whether institutional (on its own behalf or on behalf of clients) or retail[5], should be clear in giving instructions to a dealer on how a trade is to be executed and, in particular, whether there are any issues regarding the timeliness or certainty of the execution of the order. A client may be more interested in obtaining an immediate fill than in obtaining the best price possible over a longer period. This is recognized in UMIR Policy 5.1, which provides that "the desire of the client to obtain a fill quickly is always a consideration". UMIR Policy 5.1 also states that "if a client expressly consents to a principal trade on a fully informed basis, following the client's instructions will be reasonable".

d) Marketplace's role

Marketplaces have a role in ensuring the quality of their market and in providing a mechanism for price discovery that allows best execution to be obtained and measured. In addition, marketplaces have historically played a role in facilitating best execution through establishing rules that require participants to trade at the best available price ("trade-

[3] See, for example: Section 115(1) of the Regulation to the *Securities Act* (Ontario).

[4] See, for example: Section 116 of the *Securities Act* (Ontario); section 190(1) and (2) of the *Securities Act* (Alberta); section 125 of the *Securities Act* (BC).

[5] Throughout the paper, reference to "client" includes an institution dealing with a dealer on its own behalf or on behalf of another client as well as a retail client dealing with a dealer directly.

through" rules). With more electronic access to marketplaces, and the broadening of access to non-dealers, issues are currently being raised about the role of marketplaces in facilitating best execution. In particular, it is currently being debated, particularly in the United States, whether it is appropriate to place an obligation on a marketplace to establish and enforce policies and procedures to prevent trade-throughs. This may, for example, be accomplished by electronic linkages to and among marketplaces. It is recognized, however, that even if marketplaces have a role in ensuring that the best price is obtained, this does not alter a dealer's duty of best execution to its clients.

Question

Question 1: Are there any changes to current requirements that would be helpful in ensuring best execution? Do you think that clients are aware of their role in best execution or would some form of investor education be helpful?

3. What is "best execution"?

There is no simple, purely objective definition of best execution. It is difficult to define best execution because there are many factors that may be relevant in assessing what constitutes best execution in any particular circumstance. Price, for example, is often but not always the only, or even primary consideration. The intermediary must exercise judgment by taking into account considerations such as the client's objectives, the size of the order and the market in which the security trades. Indeed, this is why it is often considered more appropriate to think of best execution as the outcome of a process and not an absolute value determined on a trade-by-trade basis.

a) Elements of best execution

There are some main elements of best execution that are commonly agreed-upon: 1) price; 2) speed of execution; 3) certainty of execution; and 4) total transaction cost[6].

i) Price

For a retail-sized market order, each client is owed the best price available at the time his/her order is placed. Where a security trades in a single market, this duty is fulfilled by immediately executing the order or withholding it and executing at a better price. For a limit order, the client is owed the specified price or better if it becomes available and for other orders, the best price given the particular instructions. The duty to obtain the best price, even where the security trades only on one market, is complicated by the size of the order and the frequency with which it trades.

Where a security trades in multiple marketplaces (and possibly different countries), the duty becomes more complex and the agent is required to have access to current and complete trading information and to ensure that the transaction is executed on the market that will provide the best net price to the client.

ii) Speed of execution

While obtaining the best price generally remains the guiding principle of best execution, most clients also expect timely execution of their orders and are not prepared to wait in order to gain a slight price improvement. As automated routing and linkage of markets have become more common, clients typically expect immediate fills on market orders and in most cases consider speed of execution to be an essential element of best execution. In fulfilling the duty of best execution, a dealer must ensure that a client's order is entered on the market in a timely fashion. Further, it means that the dealer should have the capability of accessing markets that can provide timely execution. When attempting to provide price improvement on an order for a client, a dealer will have to assess the trade-off between an immediate fill and the future possibility of a better price.

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[6] Other possible elements are mentioned in the FSA's *Consultation Paper 154 on best execution* and the Committee of European Securities Regulators' (CESR) *Advice on Possible Implementing Measures of the Directive 2004/39/EU on Markets in Financial Instruments*, Consultation Paper, June 2004, such as size of order.

iii) Certainty of execution

Certainty of execution is very closely linked to speed of execution, as an immediate fill provides certainty, but it may also depend on other factors. In trading illiquid securities, for example, certainty may be provided by a dealer's knowledge of where to obtain the securities or willingness to act as principal. Any expertise or service that ensures the desired execution – especially for investors that need a particular fill at a particular time – has a value.

iv) Total transaction cost

The overall cost of a transaction must be considered when assessing whether the other elements of best execution have been met:

- Cost of execution must be considered when orders may be routed to different marketplaces. The dealer must take into account any commissions, access fees or transaction costs (including jitney fees, which may be a significant factor for smaller dealers with limited market access) that would impact the net price to the client. Thus, while a better price may be quoted on a given market, if there are costs of transacting on that market that are material, price may not be the only determining factor.

- Market impact refers to the price movement that occurs when executing an order. When a large order is entered it can cause sharp price movements, especially in an illiquid security. Even if it is broken up into smaller orders, other participants may notice the activity and respond, causing market movements that may negatively affect the remainder of the order.

- Opportunity cost relates to the missed opportunity to obtain a better price when an order is not completed at the most advantageous time. Opportunity cost is often measured in relation to risk since the trader must weigh the risk of not completing an order quickly and missing the best price against waiting for a better price and instead having the market move against him or her.

b) Measurement

Critical to any analysis of the principles of best execution is the degree to which any dealer or adviser (and each of their respective clients) is able to measure the execution quality of a trade. The general consensus among regulators and the market participants we spoke with was that, in order to track best execution in terms of price, dealers and advisers should make efforts to measure the quality of execution on a regular basis by tracking and comparing the quote at the time the order was placed against possible benchmarks such as the post-trade quote, the closing price or the volume-weighted average price (VWAP). Where factors other than price have been identified as key, records of orders should be clear and there should also be processes in place to review such orders against executions.

During our informal consultations, it was generally acknowledged that it can be difficult to determine the appropriate means of measurement. One reason is that it depends, to a large extent, on the elements relevant to best execution, which are not all clearly delineated in any

specific requirements or guidance today and will vary in accordance with a client's instructions. In addition, there are issues concerning the ready availability of appropriate data to measure the quality of trades. Based on the feedback we received, it appears that some dealers and advisers have adopted specific policies and procedures within their firms as well as specific tools and technology for measurement, while others rely on relatively *ad hoc* processes. Some of those in the former group utilize sophisticated analytical tools to measure execution quality or specialized services that provide trading analytics useful for measurement.

Part 11 of NI 23-101 requires dealers to record certain information relating to orders and trades and to transmit that information to a regulation services provider or a securities regulatory authority. This information is required to be in electronic form by the earlier of January 1, 2007 and the date on which a self-regulatory entity or a regulation services provider implements a rule that sets such a requirement. Examples of the required information include the date and time that an order is first originated and any client instructions or consents respecting the handling or trading of the order, if applicable. Such audit trail information is currently available for measuring execution quality, but not always in electronic form.

c) Description for purposes of discussion

Some jurisdictions have described what best execution means[7]. Although we have general best execution obligations in Canada, there is no guidance on what "best execution" means, beyond the focus on best price, or how to achieve it. In order to provide context for the discussion in this paper, based on the descriptions of best execution in other jurisdictions and the elements discussed above, we are setting out a proposed description: best execution means *the best net result for the client, considering the relevant elements (including price, speed of execution, certainty of execution, and total transaction cost) in light of the client's stated investment objectives.* In practice, the best execution obligation is met by seeking to achieve this best net result and not necessarily by meeting an absolute standard. The specific application of this principle will vary with the needs of clients and with the particular security but, if challenged on whether best execution was achieved for a particular trade, the agent should be able to demonstrate that it has a defined process and that it has taken reasonable care in relying on this process.

Once the feedback has been analyzed, if we determine that this description or a similar description is appropriate, we would need to consider how to incorporate it into the overall best execution framework.

Questions

[7] The SEC has stated that the duty of best execution requires a broker-dealer to seek the "most favorable terms reasonably available under the circumstances for a customer's transaction". The FSA, in reformulating the best execution obligation, adopted the approach that it should be seen more as the result of an investment decision-making process rather than solely based on best price for the customer on a single transaction. CFA Institute Trade Management Guidelines describe best execution as a process that investment management firms apply to seek to maximize the value of a client's portfolio within the client's stated investment objectives and constraints. See also CFA Institute's *Asset Manager Code of Conduct Exposure Draft* (November 2004).

Question 2: ***Should there be more prescriptive rules than those which currently exist for best execution or should the methods for meeting the best execution obligation be left to the discretion of registrants?***

Question 3: ***Do you believe that there are other elements of best execution that should be considered? If so, please describe them.***

Question 4: ***If audit trail information is not in easily-accessible electronic form, how is the information used to measure execution quality? Is there other information that provides useful measurement?***

Question 5: ***Do you believe the suggested description emphasizing the process to seek the best net result for a client is appropriate and provides sufficient clarity and, if not, can you suggest an alternative description?***

4. Market Structure Issues

a) Market fragmentation

As described above, in executing a client order a dealer must generally seek the best price, taking into account any costs incurred so that the net result is most beneficial to the client. A primary consideration is whether the dealer has access to the best price at the time of execution. In order to achieve this result, the dealer must have access to timely market information to determine where the best price exists and must have access to the applicable market to get that price.

When a security trades on multiple marketplaces, it is more difficult to ensure that an order was filled at the best price available at the time of execution. The growth of trading in ATSs in recent years, particularly in the US, has given rise to concerns about market fragmentation in the context of best execution.

Market fragmentation has not been a significant issue in Canada in recent years for Canadian-only listed equity securities since there are single markets for senior equities, junior equities, financial derivatives and commodity contracts. However, the establishment of the ATS rules in 2001 opened the door for new systems to become established and means that the issues seen in the US will likely be faced in Canada.

For inter-listed securities, market fragmentation becomes more of a consideration. However, the market participants that were consulted did not believe that there were serious issues with inter-listed equity securities for two reasons. First, they stated that, as a result of the exchange rate, orders are generally filled in Canada unless the client has specified that the order should be routed to a US market. Second, many added that they believe that the degree of automation and arbitrage has resulted in efficient markets, so a client would receive the best price regardless of whether the order was routed to a Canadian or US market (given the variable of foreign exchange). If a dealer is routing an order for execution on a US market to another dealer, the issues described below in relation to foreign listed equity securities would apply.

Finally, for foreign-only listed equity securities, it is more difficult to ensure that best execution is obtained. Dealers have an obligation to choose executing brokers in accordance with best execution principles and to monitor the quality of execution. Although some dealers were able to provide details of how they measure and evaluate their executing brokers, many market participants consulted were not able to provide such details. Some dealers may choose an executing broker based on reciprocal business and, until recently, many based their decision on payment for order flow arrangements (this service appears either to have been reduced or discontinued). However, the question arises as to whether a dealer who chooses an executing broker based on payment for order flow or reciprocal business alone, without analyzing all factors, is acting in the best interest of the client. Critics of these practices argue that the benefit in these cases goes to the dealer and not the client and thus constitutes a conflict of interest. Further, if the dealer in Canada is basing the decision on such factors alone, and not measuring the quality of the execution provided by the executing broker, how is best execution ensured?

b) Internalization

The practice of internalization refers to the crossing of orders by dealers. It includes (a) trades done as agent on both sides of the transaction and (b) trades in which the dealer acts as principal in filling a client's order. When internalization occurs (regardless of any obligation to print on an exchange and meet other exchange requirements), it must be done within the context of best execution obligations. When client orders are crossed, the requirements of both clients must be taken into account and they are both owed best execution.

There has been significant debate on the subject of client-principal transactions and whether a dealer can act in the best interest of its client when also acting as a principal. With respect to Canadian equity marketplaces, there are specific requirements for client-principal transactions. In particular, under UMIR section 6.3, the dealer cannot trade as principal against client orders of less than 5,000 shares unless it provides price improvement, i.e., provides a price at least one price increment better than the existing market quote. The benefit of dealers trading on their own behalf is that they provide much needed liquidity to the market, which results in narrower spreads and/or additional volume (liquidity), thereby assisting in the achievement of best execution. This must be balanced against the inherent conflict of interest in client-principal trading and the concern that when a large portion of orders are internalized this causes fragmentation and has the potential to negatively affect the price discovery mechanism.

c) Structure of market

Understanding that different considerations flow from different types of markets is necessary to make a full assessment of best execution. Relevant factors include the ability to see the price that the security is trading at, the volume at that price and whether the security has been trading regularly. As part of this assessment, the usual liquidity of a particular security is also important. Further, although best execution must be sought for all transactions regardless of the type of market, there are constraints that are applicable when trading in certain markets.

i) Auction markets

Continuous auction markets typically have greater transparency, which allows participants to have access to pre-trade and post-trade information. Best execution issues in a continuous auction market tend to focus on order handling, the amount of internalization and the ability to obtain the best price if the security is inter-listed. This applies to any type of security traded on a continuous auction market.

Particularly when trading less liquid securities, showing an order and/or information leakage resulting from seeking the other side may have an impact on the execution. As a result, some continuous auction markets have established special facilities. For example, the Toronto Stock Exchange (TSX) has implemented order types (anonymous and iceberg) and special facilities that allow anonymous trading and are designed to reduce market impact. The TSX market-on-close (MOC) facility establishes the closing price for specified TSX securities by accepting anonymous MOC orders throughout the day, broadcasting the imbalance twenty minutes before the close, and by running an electronic call at the close. In

addition, POSIT, an electronic order matching system that prices trades at the mid-point of the bid and ask on TSX, was in place for several years[8].

ii) Over-the-counter trading

Currently, for equity securities trading OTC, trading information is not publicly available. In Ontario, information on OTC equity trades is required to be reported to the Canadian Unlisted Board (CUB) for monitoring and surveillance purposes. Generally, the requirements applicable are those under the electronic audit trail requirements in NI 23-101 and IDA requirements relating to books and records.

In addition, the debt market continues to be predominantly a dealer market and has historically operated in a non-transparent fashion. Although the recent emergence of two debt ATSs and the distribution by CanPX of benchmark government debt and certain corporate debt information have provided greater transparency than previously available, the majority of debt trading is not transparent. There are general requirements set out in IDA Policy 5 *Code of Conduct for IDA Member Firms Trading in Domestic Debt Markets*. IDA Policy 5 emphasizes that dealers should act fairly, honestly and in good faith when dealing in the debt market.

The lack of transparency in the OTC market generally makes it more difficult to assess execution quality. Given data availability constraints, measurement becomes a more complex exercise. In addition, securities trading in the OTC market often have less liquidity and are subject to greater price movements when an order is executed. In order to achieve best execution, the unique nature of OTC trading may result in a dealer taking longer to complete a transaction and taking on principal risk (which leads to a higher cost). One issue to consider is whether dealers and advisers should be required to obtain multiple quotes (where possible) for a particular security in order to ensure that the best price is received.

Questions

Question 6: Do you believe that there are any significant issues impacting the quality of execution for:
- ***(a) Listed equities – whether Canadian-only, inter-listed or foreign-only;***
- ***(b) Unlisted equity securities;***
- ***(c) Derivatives; or***
- ***(d) Debt securities?***

Question 7: How should dealers in Canada monitor and measure the quality of executions received from foreign executing brokers?

Question 8: Do you think that internalization of orders represents an impediment to obtaining best execution?

Question 9: Should there be requirements for dealers and advisers to obtain multiple quotes for OTC securities? Should there be a mark-up rule that

[8] TSX closed POSIT on December 31, 2004.

would prohibit dealers from selling securities at an excessive mark-up from their acquisition cost (similar to National Association of Securities Dealers, Inc. (NASD) requirements dealing with fair prices)?

Question 10: How is best execution tracked and demonstrated in a dealer market that does not have pre- or post-trade transparency such as the debt or unlisted equity market?

5. Potential Barriers to Achieving and Measuring Best Execution

a) Soft dollars and bundled services

"Soft dollars" refers to the practice by advisers of using commission dollars to pay for trading-related goods or services in addition to paying for trade execution. That is, historically, full-service dealers have provided other services, such as incidental advice, research and analytical tools, with trade execution ("bundled services"). "Soft dollar arrangements" is often used to refer to both bundled services and to the practice of advisers directing part of the commissions paid to dealers to third parties.

OSC Policy 1.9 and Autorité des marchés financiers (AMF) Policy Statement Q-20, both entitled "*Use by dealers of brokerage commissions as payment for goods or services other than order execution services ("soft dollar" deals)*" outline allowable practices in the use of commission dollars for payment for goods or services other than order execution. These policies provide that commission dollars may not be used for payment of "goods or services" other than "order execution services" or "investment decision-making services". "Investment decision-making services" is defined as:

(a) advice as to the value of securities and the advisability of effecting transactions in securities,
(b) analyses and reports concerning securities, portfolio strategy or performance, issuers, industries, or economic or political factors and trends, and
(c) data bases or software to the extent they are designed mainly to support the services referred to in (a) and (b),

whether the services are provided by a dealer directly or by a third party.

Only recently have buy-side institutions begun to request a separation of the services provided by full-service dealers to allow them to negotiate execution-only commissions. This has led to analysis of soft dollar arrangements from both the full-service and third party provider perspective. For clarity, we refer to the payment of third party services as soft dollar arrangements, and the services provided by a full-service dealer as bundled services.

Although issues relating to soft dollar arrangements could form the basis of a separate paper, we have discussed them here as they are linked to best execution. Any arrangements that may cause complexity in measuring the quality of execution, may impact on registrants' incentives, or may result in increased cost to clients should be analyzed when considering best execution issues. Soft dollar arrangements have all of these characteristics, as described below.

(i) Soft dollar arrangements

Typically, a portion of the "soft dollar" commission charged goes to pay a third party provider for certain goods or services and the rest remains with the executing dealer.

One argument in favour of soft dollar arrangements is that their use allows independent research providers to compete with large full-service firms that provide bundled execution

and research services, an extremely important factor in today's environment where independent research has become a priority.

Those in favour of soft dollar payments have argued that there are benefits to the practice, although there may be room for abuse at present. Many believe that soft dollar payments should be expressly limited to paying for third party research services or technology services which provide direct input to the decision-making process of the adviser and supporters of the concept have suggested that the only rule change that is required is to clarify the scope of services allowed and to limit those services which are considered to be "investment decision-making services". Many have suggested that soft dollar services currently may, but should not, include the following types of goods or services:

- computer hardware and software used in the administrative functions of the business, e.g. accounting software used by an adviser in managing its business;
- newspapers, magazines, trade journals;
- travel, educational conferences, courses or materials;
- quote machines, order routing terminals and networks; and
- televisions and communication services such as satellite or cable services[9].

Critics of soft dollars contend that dealers do not work as diligently on an order when they know the trade is a soft dollar trade, since they are being paid a fraction of their usual commission. For this reason, some advisers have stated that they have adopted a practice of not identifying soft dollar orders at the time of the trade but instead will provide an allocation breakdown of soft dollar commission at month or quarter end to their dealers. This may cause difficulties in accounting for soft dollars – for example, if the dealer has already taken in the commission payment as revenue, how is a payment to a third party service provider accounted for? Finally, critics of soft dollar payments argue that it may result in the costs being paid by one client or a few clients even though the benefit derived from the services applies to a number or all of the adviser's clients. This would cause a disconnect between who pays for the service and who receives the benefit.

In some examples of soft dollar arrangements, a mark-up is applied and in others, the regular negotiated commission is charged. In any case where there is a mark-up applied above a "regular" bundled commission, it is difficult to understand how the client receives best execution. Even if there is no mark-up, since the adviser could arguably negotiate a lower commission for execution only, critics state that the overall cost to the client when using soft dollar arrangements is too high and is counter to achieving best execution. It is also difficult to measure whether best execution is obtained in the case of soft dollar arrangements as the trading commissions that are at the base of the arrangements sometimes include services from dealers that are bundled and sometimes are for execution-

[9] Recently, the FSA published a supplementary policy statement clarifying the goods and services that could be purchased with commission. The FSA characterized certain services as "non-permitted services" (such as computer hardware, travel, seminar fees and subscriptions for publications) and provided additional information about "permitted services". An NASD Task Force also issued a report on soft dollars which included a recommendation that the SEC adopt an illustrative list of what items would be included in or excluded from the definition of "research services" and from time to time publish a new list or other interpretive assistance. This is discussed in more detail in the next section of the paper dealing with other jurisdictions' initiatives.

only. Those who are most opposed to soft dollar arrangements believe that the practice constitutes a misuse of client assets to pay for services which should rightly be considered an expense of the adviser in doing business[10].

An adviser using soft dollar arrangements may have difficulty meeting its general obligations to its clients as a result of the following:

- there may be issues concerning disclosure, where a service such as research is paid for by the adviser's clients with commission dollars, allowing the adviser to avoid purchasing the research with its own funds and including it as an expense;
- the adviser could potentially reduce costs in a poorly performing portfolio by using research and other services paid for by other portfolios; and
- the selection of dealers may be biased by the existence of soft dollar arrangements rather than being based on the quality of trade execution.

There are a number of potential conflicts of interest associated with soft dollar arrangements that may not be directly linked to best execution. In general terms, conflicts of interest arise in any situation where there are incentives or practices that create the potential for an adviser's interests to be put before a client's interest. Any use by an adviser of commissions for its own benefit would be a conflict of interest. This is recognized in OSC Policy 1.9 and AMF Policy Q-20 which provide that "commissions [on brokerage transactions executed on behalf of a manager of a portfolio or fund of securities] must only be used as payment for goods or services which are for the benefit of the beneficiaries and should not be used as payment for goods or services which are for the benefit of the manager".

ii) Unbundling of services/commissions

The policies relating to soft dollar arrangements do not distinguish between third party services and bundled services provided by full-service dealers. However, since full-service dealers have not traditionally charged directly for any services supporting trading, such as research and trading analytics, values are not easily assessed. Research has been referred to as a "free" service as well as one that can be paid for after it is received to reflect its actual value to the recipient.

Many believe that the concept of paying for third party research using commission dollars is no different than paying a "bundled" commission which represents payment for in-house proprietary research and trading-related services as well as execution. Therefore, they contend that, if soft dollar payments were to be prohibited, it should be done concurrently with the unbundling of full-service commission dollar payments.

iii) Disclosure

A significant current issue concerning soft dollars is transparency. A commonly-held view among market participants is that, if advisers were to provide greater disclosure to their clients regarding the use of commission dollars, then the issue would not be as critical. They believe that clients have the right to know how their commission dollars are being used and to determine whether they believe that the adviser is acting in their best interests.

[10] FSA, *Bundled brokerage and soft commission arrangements, Feedback on CP 176*.

Currently, there are certain disclosure requirements applicable to soft dollar arrangements. OSC Policy 1.9 and AMF Policy Statement Q-20 provide that the annual information form or prospectus of a mutual fund must disclose the names of persons who have provided "investment decision-making services" with a summary of the services, where remuneration for those services was paid through commission on transactions executed on behalf of the mutual fund. This disclosure requirement has been incorporated into National Instrument 81-101 *Mutual Fund Prospectus Disclosure* (see section 10.4(2) of Form 81-101F2 Contents of Annual Information Form). It is also proposed in National Instrument 81-106 *Investment Fund Continuous Disclosure*[11] (NI 81-106) that the notes to the financial statements of an investment fund include details of the total commission paid to dealers, specifying the amount of commissions paid and the amount of soft dollar transactions.

iv) Accounting issues

Soft dollar arrangements and bundled services give rise to questions as to the appropriate accounting for such arrangements. For example, current practice in the mutual fund industry is to treat the entire commission for the portfolio transaction, regardless of whether it includes an element of compensation for provision of third party services, as either part of the cost of acquisition of an investment or as a reduction in the proceeds of a sale of an investment, as appropriate. As a result, the commission is ultimately reflected in the financial statements as a change in the realized and unrealized gain or loss on portfolio securities rather than as a component of operating expenses. This practice affects the management expense ratio (MER), a key ratio used by investors to screen and compare mutual funds, since the MER is required to include only those costs that are treated as expenses in the financial statements. A fund using commissions to pay for operating expenses such as acquiring research reports would disclose a lower MER than a fund that pays separately for the same or similar research reports.

As a result of the accounting treatment, investors are not in a position to evaluate how much is spent on "investment decision-making services" as opposed to order execution. Some believe at least part of the "investment decision-making services" portion of the commission represents a cost of the purchase or sale of securities as these services assist in the selection of securities for purchase or sale. Others are of the view that only the cost of order execution is a direct cost of the purchase or sale of securities. However, those who hold the latter view are concerned that the measurement difficulties are such that the arrangements cannot always be split into component parts. They suggest that only those commission arrangements for which the "investment decision-making services" portion can be reliably measured should be split.

b) Directed brokerage

Directed brokerage refers to the practice by advisers of using commission payments as incentives for dealers to provide some type of preferential treatment. There are different types of directed brokerage. One type – where transactions of a mutual fund are directed to a dealer as inducement or reward for the dealer selling securities of the mutual fund – is prohibited in National Instrument 81-105 *Mutual Fund Sales Practices* (NI 81-105). In

[11] Proposed NI 81-106 was published for comment on May 28, 2004.

particular, section 6.1(4) of NI 81-105 prohibits directing transactions of the mutual fund to a dealer as inducement or reward for the dealer selling securities of the mutual fund.

All forms of directed brokerage involve transactions that are directed to a dealer in return for some benefit. This may include a dealer providing client referrals or providing the opportunity to participate in hot new issues. An adviser may also direct transactions to an affiliate firm in which it has an equity interest.

In any of these cases, the adviser is using clients' commission dollars to receive a benefit that may not be directly returned to the same clients or may even benefit only the adviser. Directing commissions to a dealer in return for some benefit to the adviser represents a conflict of interest since the adviser may be placing its own interest ahead of its clients' interests and, among other things, best execution may not be achieved. Further, it can be argued that, when any factor other than the quality of execution is the primary reason for choosing a dealer, then the duty of best execution has been compromised.

Initial feedback indicates that many participants believe that directed brokerage is not a serious issue in Canada today and that most advisers choose to divide their business among a selected list of dealers based on quality of execution. Again, several participants have commented that if advisers are required to disclose their top dealers and the criteria used in choosing those dealers, then the issue would be minimized.

c) Commission recapture

Commission recapture arrangements allow institutional investors to track the amount of commission dollars and, if available, receive back certain amounts. Under a commission recapture program a dealer will generally return to an adviser's clients a portion of the commission dollars paid. Those in favour of commission recapture argue that the practice amounts to a volume discount for large entities who generate significant commission revenue and that the amounts returned go to the benefit of the clients. A number of firms specialize in commission recapture programs and actively market this service to institutional investors.

Opponents of commission recapture programs contend that the very fact that commission recapture exists indicates that clients have been paying higher commissions than necessary (i.e., if the practice is so inefficient that an intermediary can make a business out of it, it must mean the client is paying fees that are too high). Further, critics of commission recapture also state that the dollars may not necessarily be returned to the clients' pool of assets but may be used to defray the expenses of the fund administrator and thus are not any different than soft dollars. Some advisers commented that when a client specifies which dealer must be used for execution, then they (the adviser) have lost the ability to choose a dealer based on the quality of execution, and this compromises their duty to provide best execution to their clients.

Questions

Question 11: How does an adviser ensure that its soft dollar arrangements are consistent with its general obligations to its clients?

Question 12: ***Are there any other additional benefits or concerns with soft dollar arrangements that are not noted above?***

Question 13: ***If it is acceptable to pay for goods or services using soft dollars, which services should be included as "investment decision-making services" and "order execution services" and which services should specifically not be included?***

Question 14: ***Should there be additional disclosure requirements beyond those specified in OSC Policy 1.9 and AMF Policy Statement Q-20, National Instrument 81-101 and proposed in National Instrument 81-106? Should the disclosure requirements be the same for third party soft dollar payments and bundled commissions?***

Question 15: ***What, if any, are the practical impediments to an adviser:***

- ***(a) splitting into their component parts commission payments that compensate for both order execution and "investment decision-making services" as a result of either third party soft dollar arrangements or bundled commissions; or***
- ***(b) making a reasonable allocation of the cost of "investment decision-making services" to the beneficiaries of those services (for example, allocating across mutual funds)?***

Question 16: ***If the split between order execution and "investment decision-making services" cannot be measured reliably, should the entire commission be accounted for as an operating expense in the financial statements? If it can be measured reliably, should the "investment decision-making services" portion of commission payments be accounted for as an operating expense in the financial statements?***

Question 17: ***Would it be appropriate for the MER to be based on amounts that differ from the expenses recognized in the audited financial statements? For example, should the entire commission continue to be accounted for as an acquisition/disposition cost in the financial statements but the MER calculation be adjusted either to include all commissions or to include only that portion that is estimated to relate to "investment decision-making services"?***

Question 18: ***Should directed brokerage or commission recapture arrangements be limited or prohibited?***

Question 19: ***Should disclosure be required for directed brokerage or commission recapture arrangements?***

6. Other Jurisdictions' Initiatives

a) United States

In the United States, the duty of best execution has been discussed in various SEC releases and is incorporated in self-regulatory organization (SRO) rules. The SEC has stated that the duty of best execution requires a broker-dealer to seek the "most favorable terms reasonably available under the circumstances for a customer's transaction"[12]. NASD Rule 2320 requires a member to use reasonable diligence to ascertain the best inter-dealer market for a security and to execute in such market so that the price to the customer is as favorable as possible under prevailing market conditions[13]. In addition, NASD members are required to obtain quotes from three dealers (or all dealers if less than three) to determine the best inter-dealer market for non-NASDAQ securities, unless two or more quotes are displayed on an inter-dealer quotation system.

In addition, the SEC adopted Rules 11Ac1-5 and 11Ac1-6 under the *Securities Exchange Act of 1934* (1934 Act) concerning disclosure of order routing and execution practices. Rule 11Ac1-5 requires market centers that trade national market system securities to make monthly, electronic disclosures of basic information concerning their quality of executions on a stock-by-stock basis. Such information includes, for example, how market orders of various sizes are executed relative to the public quotes. Rule 11Ac1-6 requires brokers that route orders on behalf of customers to disclose, on a quarterly basis, the identity of the market centers to which they route a significant percentage of their orders. In addition, brokers are required to disclose the nature of their relationships with such market centers, including any internalization or payment for order flow arrangements that could represent a conflict of interest between the broker and its customers. Brokers are also required to respond to the requests of customers interested in learning where their individual orders were routed for execution during the previous six months.

In a release issued by the SEC in 1986[14] (1986 Release), the SEC emphasized that money managers are obligated to obtain best execution of clients' transactions under the circumstances of the particular transaction. The SEC stated that the determining factor in assessing whether a money manager has obtained best execution is not the lowest possible commission cost but whether the transaction represents the best qualitative execution for the account.

In order to address concerns related to soft dollars, the US Congress enacted section 28(e) of the 1934 Act in 1975 in order to provide a safe harbor to money managers who use commission dollars to obtain investment research and brokerage services provided that certain conditions are met. The background to this provision was set out in the 1986 Release. In connection with the abolition of fixed commission rates on May 1, 1975, money managers and broker-dealers expressed concern that if money managers were to pay more than the lowest available commission rate to a broker-dealer in return for services other than execution, such as research, they would be exposed to charges that they had breached a

[12] Securities Exchange Act Release No. 34-37619A.
[13] In April 2001, the NASD issued Notice to Members 01-22 to reiterate best execution obligations that apply to members when they receive, handle, route for execution or execute client orders.
[14] Securities Exchange Act Release No. 34-23170 (April 23, 1986).

fiduciary duty[15]. Section 28(e) clarifies that money managers may consider the provision of research, as well as execution services, in evaluating the cost of brokerage services without violating their fiduciary responsibilities.

The SEC is currently reviewing soft dollar arrangements. In the spring of 2004, the Chair of the SEC set up an internal task force to review soft dollar arrangements[16]. In addition, in May 2004, NASD formed a Mutual Fund Task Force (NASD Task Force) to consider mutual fund portfolio transaction costs including directed brokerage, soft dollars and disclosure. In November 2004, the NASD Task Force issued a report with recommendations concerning soft dollars. The NASD Task Force concluded that the safe harbor in section 28(e) should be preserved and made a number of recommendations including that the SEC:

- narrow its interpretation of the scope of research services for purposes of the safe harbor to better tailor the safe harbor to the types of services that principally benefit clients rather than the adviser (and protect only brokerage services and the "intellectual content" of research[17]);
- ensure that a fund board obtains appropriate information regarding a fund adviser's brokerage allocation practices including soft dollar products and services received; and
- mandate enhanced disclosure in fund prospectuses to foster better investor awareness of soft dollars.

In recommending that the SEC interpret the safe harbor to protect only brokerage services and the "intellectual content" of research, the NASD Task Force proposed that the SEC include an illustrative list of what items would be included or excluded from the definition.

In addition, the SEC enacted a rule, effective October 14, 2004, that prohibits funds from paying for the distribution of their shares with brokerage commissions (which is similar to the prohibition contained in National Instrument 81-105 *Mutual Fund Sales Practices*).

Recently, the SEC proposed revisions to the National Market System in Regulation NMS. Regulation NMS contains four proposals that address the following topics: (1) trade-throughs; (2) intermarket access; (3) sub-penny pricing; and (4) market data. Subject to two major exceptions, the proposed trade-through rule would require an order execution facility, national securities exchange and national securities association to establish, maintain and enforce policies and procedures reasonably designed to prevent the execution of a trade-though in its market. The SEC emphasized that the trade-through rule, including the exceptions, in no way alters or lessens a broker-dealer's duty to achieve best execution for

[15] Securities Exchange Act Release No. 34-23170 (April 23, 1986).
[16] The task force is comprised of SEC staff from five divisions and offices.
[17] The NASD Task Force proposed that the SEC define "intellectual content" as "any investment formula, idea, analysis or strategy that is communicated in writing, orally or electronically and that has been developed, authored, provided or applied by the broker dealer or third party research provider (other than magazines, periodicals or other publications in general circulation)". The proposed definition would not protect such benefits as computer hardware and software unrelated to any research content or analytical tool, phone lines and data transmission lines, terminals and similar facilities, magazines, newspapers, journals, on-line news services, portfolio accounting services, proxy voting services unrelated to issuer research and travel expenses incurred in company visits.

its customers' orders and a broker-dealer must carry out a regular and rigorous review of the quality of market centers to evaluate their best execution policies[18].

b) United Kingdom

Section 7.5 of the FSA's Conduct of Business Sourcebook deals with best execution. In general terms, a firm must take reasonable care to ascertain the best available price and execute customer transactions at this price or a better price, unless the firm has taken reasonable steps to ensure that it would be in the customer's interests not to do so.

In October 2002, the FSA published Consultation Paper 154 on best execution (CP 154). In reformulating the best execution obligation, the FSA adopted the approach that it should be seen more as the result of an investment decision-making process rather than solely based on best price for the customer on a single transaction. The FSA proposed that firms provide information to their customers about their execution arrangements such as details of order-routing practices and the existence of conflicts or incentives that might affect order-routing decisions. In addition, the FSA stated that, as execution quality can be influenced by the approach firms adopt, firms should monitor their execution performance. With respect to disclosure obligations, the FSA acknowledged that there might be sound reasons for imposing different disclosure requirements for investment managers given the nature of the service provided.

In April 2003, the FSA published a related consultation paper, CP 176 – *Bundled brokerage and soft commission arrangements*[19]. Prior to this, in 2001, a review of institutional investment in the United Kingdom, prepared by Paul Myners, identified problems arising from the use of bundled brokerage and soft commission arrangements by asset managers. The FSA had agreed that it would review those matters further and make proposals for regulatory change if necessary. CP 176 therefore proposed two main measures:

- Limiting the range of goods and services that could be purchased with commissions; and
- Requiring fund managers to value the goods and services that could still be softed or bundled and to rebate an equivalent amount to their customers' funds.

CP 176 generated nearly 150 responses. In May 2004, the FSA published *Bundled brokerage and soft commission arrangements, Feedback on CP 176,* and suggested that three changes were necessary:

- The range of goods and services that fund managers can buy with their clients' funds through commission payments should be limited to execution and research;

[18] Regulation NMS, Release No. 34-49325 (February 24, 2004) at p.23.

[19] Bundled brokerage is defined in CP 176 as an arrangement in which a broker provides a client (e.g. a fund manager) with a combination of trade execution services and other services, such as investment research, paid for through commissions. The components of the bundle are not usually offered or priced as separate services. Soft commission arrangements are described as those where the fund manager receives goods and services (usually from third parties) which are paid for by the broker. There is an explicit prior agreement that links the value of the softed goods and services to a specified volume of commission from orders.

- Fund management clients should be given, through enhanced disclosure, clear information about the respective costs of execution and research paid for on their behalf by their manager and the overall expenditure on these services; and
- Fund managers should be encouraged to seek, and brokers to provide, clear payment and pricing mechanisms that enable individual services to be purchased separately. The FSA believes that the existence of such mechanisms will facilitate better decision-making[20].

The FSA also stated that they were looking to industry to develop the disclosure proposal. The Investment Management Association (IMA) has been developing a new system of "comparative disclosure" to show the breakdown between the costs of execution and the costs of research.

In November 2004, as follow-up to the May 2004 paper, the FSA published a policy statement[21] setting out the FSA's views on what should be covered by the terms "execution" and "research". The FSA proposed to set an "outer-perimeter" for permitted commission payments and draw a distinction between non-permitted goods and services on one hand and execution and research on the other hand. Services classified as "non-permitted services" are those that are not sufficiently connected with particular investment management decisions or transactions to be classified as execution or research. These include services related to the valuation or performance measurement of portfolios, computer hardware, seminar fees, subscriptions for publications, travel, accommodation or entertainment costs, membership fees to professional associations and employees' salaries. The FSA views execution as consisting of services provided by a broker that are demonstrably linked to the arranging and conclusion of a specific transaction (or series of transactions) and arise between the point at which the fund manager makes an investment decision and the point at which the transaction is concluded. With respect to research, the FSA concluded that research should be capable of adding value by providing new insights to inform fund managers when making investment or trading decisions and should not include raw data feeds or information that is generally publicly available. The FSA also provided an update on the progress made with the industry disclosure proposal.

c) Australia

In 1997, the Australian Securities and Investment Commission (ASIC) issued Policy Statement 122 *Investment advisory services: the conduct of business rules* (s.849 and s.851). Policy Statement 122 (PS 122) set out ASIC policies and guidelines on how persons making securities recommendations to investors could meet the Conduct of Business Rules in the *Corporations Act* (Australia). In particular, PS 122.64 provided that where a securities adviser received non-cash benefits – for example, office space, computer access to research and databases, advertising rebates and subsidies, etc. – for promoting particular funds or securities, the benefits generally had to be disclosed.

[20] See "Bundled brokerage and soft commission arrangements - Feedback on CP176" published May, 2004.
[21] Bundled brokerage and soft commission arrangements, Update on issues arising from PS 04/13.

Effective March 11, 2004, disclosure requirements were revised[22], in part to include disclosure for advice on any type of financial product, not just securities, as was previously the case.

When a potential retail client approaches an adviser, the adviser must give the consumer a Financial Services Guide (FSG). The FSG must disclose:

- All remuneration, commissions and other benefits attributable to the provision of any of the authorised services (e.g., advice); and
- Associations and relationships with the issuers of any financial product that might be capable of influencing advice.

When a retail client gets personal advice, the adviser must provide a Statement of Advice (SOA). A SOA must disclose:

- Remuneration, commissions and other benefits;
- Other interests; and
- Associations and relationships with the issuers of any financial product that might be capable of influencing the advice (or any other authorised service).

In June 2004, ASIC released a research report on soft dollar benefits in the financial planning industry[23]. The report explores a broad category of "soft dollar benefits", a term which is used to mean all benefits except:

- Direct client advice fees; and
- Basic monetary commissions that financial advisers and their licensees may receive if they recommend certain products.

The report describes types of soft dollar benefits, explores how conflicts of interest arise from these benefits, examines how the benefits are being disclosed to consumers and comments on what is considered good disclosure. ASIC states in the report that it will consider conducting a formal surveillance next year to ensure that disclosure of soft dollar benefits meets legal requirements.

In addition, the Australia Investment and Financial Services Association (IFSA) and the Financial Planning Association (FPA) have existing guidelines on soft dollar benefits. For example, IFSA guidelines in 1999 provided that acceptable soft dollar benefits include third party research and technical analysis software and that unacceptable benefits include travel, accommodation and entertainment costs and computer software or hardware if not associated with investment decision-making, advice or research. The FPA Code of Ethics also has a provision requiring disclosure of remuneration.

In late 2003, IFSA and FPA commenced a joint project on issues related to soft dollar benefits. In December 2003, a proposal was released for an industry code of practice on

[22] Disclosure requirements are now contained in Part 7.7 of the Corporations Act 2001 and the Corporations Regulations 2001.
[23] *Disclosure of soft dollar benefits: An ASIC research report*, June 2004.

"alternative forms of remuneration" (i.e., soft dollar benefits) and was finalized in July 2004. The proposed code is in addition to legal disclosure requirements.

Question

Question 20*: *Would any of these initiatives be helpful in Canada?

7. Comment Process

Interested parties are invited to make written submissions on the concept paper. Please provide comments in writing on or before May 6, 2005 to all of the CSA listed below in care of the OSC, in duplicate, as indicated below:

British Columbia Securities Commission
Alberta Securities Commission
Manitoba Securities Commission
Ontario Securities Commission

c/o John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
Suite 1903, Box 55
Toronto, Ontario M5H 3S8
Fax: (416) 593-2318
Email: jstevenson@osc.gov.on.ca

Please also send your submission to the Autorité des marchés financiers as follows:

Anne-Marie Beaudoin, Directrice du secrétariat
Autorité des marchés financiers
Tour de la Bourse
800, square Victoria
C.P. 246, 22e étage
Montréal, Québec H4Z 1G3
Email: consultation-en-cours@lautorite.com

A diskette containing the submissions (in Windows format, preferably Word) should also be submitted.

Comment letters submitted in response to requests for comments are placed on the public file in certain jurisdictions and form part of the public record, unless confidentiality is requested. Comment letters will be circulated among the securities regulatory authorities, whether or not confidentiality is requested. Although comment letters requesting confidentiality will not be placed in the public file, freedom of information legislation in certain jurisdictions may require securities regulatory authorities in those jurisdictions to make comment letters available. Persons submitting comment letters should therefore be aware that the press and members of the public may be able to obtain access to any comment letters.

Questions

Please refer your questions to any of the following people:

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