

UPDATE ON CONCEPT PAPER 23-402 *BEST EXECUTION AND SOFT DOLLAR ARRANGEMENTS* - CANADIAN SECURITIES ADMINISTRATORS STAFF NOTICE 23-303

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Introduction

On February 4, 2005, the Ontario Securities Commission (OSC) along with the British Columbia Securities Commission (BCSC), the Alberta Securities Commission (ASC), the Manitoba Securities Commission (MSC) and the Autorité des marchés financiers (AMF) published for comment Concept Paper 23-402 *Best execution and soft dollar arrangements* (CP 23-402).

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. We stated that, based on the feedback obtained through the consultation process, we would consider the appropriate next steps.

This notice provides an update on CP 23-402, the comments received and recent developments. The notice also discusses the process going forward.

Comments received

The comment period for the concept paper ended on May 6, 2005 and we received 28 comment letters. A summary of comments is attached as Appendix A to this notice. We thank the commenters for taking the time to consider CP 23-402.

In order to move forward, we have divided the issues and comments into four main areas:

1. Definition of best execution and current requirements

In CP 23-402, we reflected the commonly held view that there is no simple, purely objective definition of best execution. We emphasized that 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. Best execution has often been equated with achieving the best price, but has more recently been described as a process rather than

a specific outcome for each trade. We suggested some key elements of best execution that are commonly agreed-upon: 1) price; 2) speed of execution; 3) certainty of execution; and 4) total transaction cost. We also raised the issue of measurement, as this is critical to any meaningful analysis of best execution.

Many commenters stated that the current best execution requirements in National Instrument 23-101 *Trading Rules* and the Universal Market Integrity Rules are too narrow as they focus on “best price”, whereas best execution is a process that includes many elements. There was general agreement with the main elements noted in the concept paper. Although there was no consensus on how execution quality should be measured, some commenters thought that, if audit trail information is not easily accessible, it is difficult to measure execution quality.

2. Over-the-counter (OTC) market

We raised for discussion issues related to different types of markets. With respect to OTC market trading, we stated that the lack of transparency generally makes it more difficult to assess execution quality. We asked 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. We also asked whether a mark-up rule that would prohibit dealers from selling securities at an excessive mark-up should be adopted.

Most commenters thought that, given the size of the OTC market in Canada, a requirement to obtain multiple quotes was not necessary. With respect to mark-up rules, while most commenters supported a principles-based approach, some thought that a mark-up rule may be needed on the retail side, in order to protect unsophisticated investors.

Commenters raised other issues specific to the fixed income market, such as the lack of clear best execution rules and the fact that the low level of transparency makes the measurement of best execution difficult.

3. Soft dollar arrangements

CP 23-402 raised several issues with respect to soft dollar arrangements. We referred to OSC Policy 1.9 *Use by dealers of brokerage commissions as payment for goods or services other than order execution services* (and

similar AMF Policy Statement Q-20), which 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”. We asked for comment on a number of issues including the range of allowable services and whether there should be additional disclosure requirements.

Most commenters believed that there should be more clarity with respect to “investment decision-making services” and “order execution services” and that additional disclosure was needed. Almost all commenters also noted that disclosure requirements should be the same for third party and bundled arrangements. With respect to accounting treatment, the majority of commenters thought that commissions should not be treated as an operating expense on the financial statements. Further, even if the “order execution” and “investment decision-making services” components of commissions can be separated, the accounting treatment of these components should be consistent.

4. Directed brokerage and commission recapture

We also discussed directed brokerage and commission recapture in CP 23-402. Directed brokerage refers to the practice of advisers using commission payments as incentives for dealers to provide some type of preferential treatment. One type of directed brokerage – 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*. Commission recapture arrangements allow institutional investors to track the amount of commission dollars and, if available, receive back certain amounts. We asked whether these arrangements should be limited or prohibited and whether disclosure should be required. Some commenters raised concern with directed brokerage arrangements (that were not already prohibited) and commission recapture, but most commenters believed that full disclosure of these arrangements is appropriate.

Recent developments

United Kingdom

Since CP 23-402 was published, there have been some developments in other jurisdictions. In the United Kingdom, in March 2005, the Financial Services Authority (FSA) published proposed rules addressing concerns with soft commission and bundled brokerage arrangements. The FSA published final rules in July 2005. The new rules are effective from January 1, 2006 (there is a transition period as firms may continue to comply with the existing rules until the earlier of the expiry of any existing soft commission agreements or June 30, 2006). In general, the rules, together with industry-driven initiatives, will limit investment managers' use of dealing commission to the purposes of "execution" and "research" services and require investment managers to disclose to their customers details of how commission payments have been spent and what services have been acquired with them.

United States

In October 2005, the US Securities and Exchange Commission (SEC) published for comment interpretive guidance on money managers' use of client commissions to pay for brokerage and research services under section 28(e) of the *Securities Exchange Act of 1934*. The purpose of the interpretive guidance is to clarify the scope of "brokerage and research services".

Next steps

Based on the feedback received during the comment process, we are proceeding in the four separate areas identified above – definition of best execution and current requirements; soft dollar arrangements; OTC market; and directed brokerage and commission recapture. We are in the process of considering current requirements and assessing what, if any, changes are appropriate. Any changes to current requirements will be subject to a public comment process.

We are aiming to publish proposed changes dealing with the definition of best execution and new soft dollar requirements in the first quarter of 2006.

Questions

Questions may be referred to:

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