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Securities Law Update

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INSIDE

New rules on soft dollar arrangements and best execution obligations

CSA Notice 46-303 puts Principal Protected Notes on the radar

CSA propose stiffer rules on soft dollar arrangements and best execution

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The Canadian Securities Administrators have recently published for comment proposed National Instrument 23-102 – *Use of Client Brokerage Commissions as Payment for Order Execution Services or Research* (the Instrument) and its Companion Policy 23-102 CP (the Policy).

Under soft dollar arrangements, advisers receive equity research or other brokerage services in exchange for executing trades through a particular broker. Ontario and Quebec currently both have policies regulating soft dollar transactions: pursuant to 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 Quebec's Local Policy Statement Q-20, soft dollar commissions earned on brokerage transactions may not be used as payment for goods or services provided to a portfolio manager other than "order execution services" or "investment decision-making services". Further, OSC Policy 1.9 specifies that the goods or services received under a soft dollar arrangement must be for the benefit of the beneficiaries of the portfolio or fund, and not for the benefit of the portfolio manager. These existing policies have been criticized as too broad, subject to interpretation, and insufficient in the area of disclosure requirements.

The proposed Instrument and Policy set out a proposed new framework for soft dollar practices, clarifying the types of goods and services that may be acquired with brokerage commissions, and prescribing related disclosure. If enacted, the Instrument and Policy may require changes to how commissions are calculated and how bundled commissions are negotiated, particularly as the requirements as proposed would extend to all transactions in any type of securities where there is any commission or similar transaction based fee (i.e. including over-the-counter transactions, trades in fixed income securities, etc.). The Instrument and Policy may also increase costs for portfolio managers as items currently funded by soft dollars may be prohibited in the future, and significant additional record keeping and disclosure requirements are imposed.

The Securities Law Update is a regular newsletter prepared by members of the Securities Group at Stikeman Elliott LLP.

The Instrument and Policy

The proposed Instrument and Policy were framed in response to feedback received on a CSA concept paper published in early 2005, and are also influenced by recent US and UK initiatives on the soft dollar front (although the Instrument and Policy will likely have broader application than the US or UK rules).

The Instrument applies to all types of transactions where brokerage commissions or similar transaction based fees are charged by a dealer. In providing a framework for the use of soft dollar commissions by advisers or the charging of soft dollar commissions by the dealer, the Instrument:

- imposes duties on the adviser to ensure that soft dollars are used to benefit the client and are reasonable in relation to the value of goods and services received;
- specifies that the goods and services which may be acquired using client brokerage commissions are restricted to “order execution services” and “research”, and gives guidance on how mixed-use items are to be classified; and
- prescribes disclosure requirements for the adviser, in particular in relation to allocating client brokerage commissions according to their use.

The Instrument defines *order execution services* to include both order execution and goods and services directly related to order execution. The Policy clarifies the latter to be goods and services that are essential and integral to arranging and concluding the securities transactions that generated the commissions. These can include, for example, trading advice, custody, clearing and settlement services, as well as the provision of algorithmic trading software and raw market data to the extent they relate to the specific order. A temporal limitation applies, with the result that only goods and services provided between the point at which an investment or trading decision is made and conclusion of the transaction qualify as “order execution services”.

Research includes advice, analyses or reports relating to investments or trading. Under the Instrument, permitted research must be more than a mere restatement of raw data: it must include analysis or manipulation of data, the expression of reasoning or knowledge and original thought. It must also be provided prior to the investment decision having been made. Examples of permitted research include traditional research reports and advice on the value of securities and advisability of investing in them, quantitative analytical software, and post-trade analytics from prior transactions.

Adviser and dealer obligations

Under the Instrument, advisers may not enter into any arrangements (whether formal or informal) to use brokerage commissions as payment for goods and services other than order execution services and research (bearing in mind that it may not always be simple to determine whether a service meets these requirements, particularly in the case of mixed use items, which must be allocated reasonably). Further, advisers must act in the best interests of their client by ensuring that the order execution services or research benefits the client, that the research adds value to investment or trading decisions, and that the brokerage commissions are reasonable in relation to the goods and services received (again, there may be circumstances where this is difficult to determine). Advisers must also ensure that the soft dollar benefits received have a connection with the client whose brokerage commissions are applied in payment, and that adequate policies and procedures are implemented to ensure a reasonable and fair allocation of the goods and services.

Registered dealers are required to ensure that commissions received from advisers are only used to pay for goods and services that fall within the definition of order execution services and research. Although a registered dealer is not precluded from forwarding commissions or parts of commissions to third parties, again, these payments must be referable to order execution services and research. Depending on how this is interpreted, this could be difficult as profits derived from commissions may not be channeled in this manner.

Disclosure obligations

The Instrument requires advisers to disclose any soft dollar practices to clients initially and then periodically (at least annually). In relation to existing clients, initial disclosure is required to be made within six months from the date the Instrument comes into force or by the date periodic disclosure is required to be made, whichever comes first.

The required disclosure is quite detailed and includes, among other things: (i) a description of the arrangements naming the dealer and any third parties involved; (ii) total commissions paid for each class of security on an aggregate and client-by-client basis; and (iii) reasonable estimates of percentages paid on (A) order execution only trades, (B) trades where order execution is bundled with other services provided by the dealer, and (C) trades where a portion (and the portion must be specified) of the commission is set aside for third parties.

Advisers will be required to maintain detailed records going back over a period of five years, which must be made available to the client on request.

Implementation

In addition to inviting general comments on the Instrument and Policy, the CSA have requested comments on 15 specific questions by October 19, 2006. As such, the Instrument and Policy are unlikely to be the last word and further amendments are expected. The CSA have indicated that, once the Instrument is adopted, no phase-in period will be necessary.

Best execution

Recently, in proposed transparency-related amendments to what are known as the ATS (alternative trading system) rules, the CSA indicated that they intend to clarify that in order to meet their best execution obligations, dealers should take into account order information from all marketplaces, whether or not they are participants in such marketplaces, and take steps to access such orders as appropriate. The proposed changes also address electronic audit trail requirements and call for marketplace data information processors for each of the equity and debt markets. Comments to these amendments to proposed NI 21-101 – *Marketplace Operation* and NI 23-101 – *Trading Rules*, and related policies and forms are due by October 12, 2006.

CSA Notice 46-303 puts PPNs on the radar

Canadian Securities Regulators publish their concerns in relation to the distribution, sale and regulation of Principal Protected Notes

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On July 7, 2006 the Canadian Securities Regulators (CSA) released CSA Notice 46-303 – *Principal Protected Notes* (the Notice), detailing their concerns about the distribution and sale of this type of investment, and mapping out the CSA's proposed approach. This is not a new topic for the securities regulators in Canada, and guidance of this nature has been anticipated for a year or more.

Why are PPNs being targeted for review?

PPNs are investment products that consist of two parts: a guaranteed return of principal and a non-guaranteed potential to earn returns based on the performance of an underlying investment.

The Notice points out that not only has there been an explosion in the number and availability of these types of products on offer to retail investors in recent years, but that they are also becoming increasingly sophisticated and complex in their structure. Because many PPN products are marketed without a prospectus (either under a prospectus exemption for guaranteed debt or because they are structured to fall outside the scope of provincial securities legislation), the CSA is concerned that retail investors are not being adequately informed about the nature of and risk in investing in this type of product, and the associated fees. There is also great sensitivity to the fact that the underlying investment of a PPN might be an alternative

asset class such as a hedge fund, fund of funds or managed futures which would otherwise not be available to retail investors without a prospectus.

Key areas of concern

The Notice appears to have been triggered by the CSA's concern that increasingly complex and sophisticated PPN structures are being used as a means of distributing and exposing investors to alternative investment products which, in the CSA's view, are ripe for closer regulation as a result.

In particular, the CSA has identified the following key areas for attention:

- **Disclosure:** there is a concern that retail investors are not getting all of the information they need to make an informed investment decision. The CSA believes that as a general rule there is inadequate disclosure about how PPNs are structured and how they work. Disclosure documents often lack sufficient detail about the underlying investment, the participants and applicable fees. Poor or overly-promotional presentation of performance returns have in many cases failed to adequately profile the risks associated with these types of investments, and there is concern that investors are sometimes not alerted to the fact that the terms of a PPN frequently preclude them from selling before maturity; and
- **Know your client (KYC) and suitability obligations:** In the Notice, the CSA expresses concerns about the "retailization" of alternative investment products through the PPN market, as well as the lack of "know-your-client" and "suitability" obligations in many cases. Referral arrangements are also targeted as being deficient in some cases (presumably as a result of the Portus problems).

What is the CSA proposing to do?

The CSA proposes to monitor the structuring and marketing of PPNs generally, and to consult with industry and stakeholders about how the existing prospectus and registration exemptions are being interpreted in the PPN investment context. Whether new regulatory requirements and guidance is necessary will depend on the outcome of this consultation process.

In the interim, the CSA recommends that issuers intending to distribute and sell PPNs take steps to ensure that disclosure documentation is sufficiently clear, comprehensive and balanced to enable potential investors and their advisors to make an informed decision or recommendation. They also suggest that investors should be alerted to the applicable fees and risks associated with investing in PPNs, and to the fact that exiting the PPN early could result in a penalty. Further, the CSA is of the view that sellers of PPNs should ensure that, if required, they are properly registered to do so, are appropriately qualified and trained to sell the product, and have a sound understanding of the PPN. In light of this Notice, it would certainly make sense for registered dealers to review their internal policies to ensure that the PPNs they recommend to clients are suitable.

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