

SECURITIES LAW BULLETIN*August 2006***PROPOSED AMENDMENTS TO PERMITTED "SOFT DOLLAR" ARRANGEMENTS**

Proposed National Instrument 23-102 *Use of Client Brokerage Commissions as Payment for Order Execution Services or Research* (the "Proposed Instrument") and Companion Policy 23-102 CP (the "Proposed Policy") will establish a general framework for the use of brokerage commission dollars by advisers to pay for trading related goods or services which are in addition to order execution, commonly known as "soft dollar" arrangements. The proposals refer to the concept paper released in February 2005, which indicated that such arrangements created potential conflicts of interest, where advisers might place their interests ahead of those of their clients and potentially obscure an adviser's best execution obligations. The Proposed Instrument and Proposed Policy, if and when adopted, will replace existing policies in Ontario and Québec and will clarify the type of goods and services that may be acquired with client brokerage commissions. The Proposed Instrument also requires enhanced disclosure of soft dollar arrangements.

SIGNIFICANT ELEMENTS OF THE PROPOSED INSTRUMENT AND PROPOSED POLICY*Application*

The Proposed Instrument will apply to advisers and registered dealers in circumstances where brokerage commissions are charged by a dealer in connection with the execution of a trade in securities. The reference to "brokerage commissions" includes any commission or similar transaction-based fee, including transactions done on a net basis if a fee can be broken out.

The Proposed Framework

The Proposed Instrument indicates that advisers may not enter into any arrangements to use brokerage commissions as payment for goods and services other than *order execution services* or *research* (discussed below). Amounts paid for any order execution service or research must be reasonable in relation to the value of the order execution services or research received, research received must add value to investment or trading decisions, and the order execution services or research must benefit the client. In connection with the requirement that the goods and services must benefit the client, the Proposed Policy clarifies that the adviser should have adequate policies and procedures in place to ensure that a reasonable and fair allocation of the goods and services received is made to clients whose commissions were used as payment for these goods and services.

Registered dealers also have the obligation to ensure that commissions received from advisers on brokerage transactions are only used as payment for goods and services that meet the definition of order execution services or research. Registered dealers may forward to a third party any portion of the commissions they have charged on brokerage transactions to pay for order execution services or research provided to the adviser by that third party.

Definition of "Order Execution Services" and "Research"

The Proposed Instrument defines "order execution services" to include order execution, as well as goods and services that are *directly related* to order execution. "Order execution" means the entry, handling or facilitation of an order by a dealer, but not other tools that are provided to aid in the execution of trades. The Proposed Policy clarifies that goods and services that are directly related to order execution are those that are essential to the arranging and conclusion of the securities transactions that generated the commissions, such as custody, clearing and settlement services.

The Proposed Instrument defines “research” as advice relating to the value of securities or the advisability of effecting transactions in securities, and analyses or reports concerning securities, portfolio strategy, issuers, industries, or economic or political factors and trends. Such research must add value to an investment or trading decision. The Proposed Policy notes that research should include original thought and the expression of reasoning or knowledge, and that information that is commonly known or self-evident would not qualify. The Canadian Securities Administrators express a view that to be permitted research, the research must be provided before an adviser makes an investment or trading decision. Examples of permitted research include traditional research reports and market data that has been analyzed or manipulated to arrive at meaningful conclusions.

With respect to mixed-use goods and services (those that contain some elements that meet the definitions of order execution services or research, and other elements that do not, or that do not otherwise comply with the instrument), the Proposed Policy indicates that the adviser should make a reasonable allocation of the amounts paid according to their use, and should keep adequate books and records concerning the allocation.

Non-permitted goods and services are those that lack a clear connection to specific securities transactions, as well as goods and services that primarily relate to the operation of an adviser’s business. Examples include mass-marketed or publicly available information or publications, and trading surveillance or compliance systems.

The Proposed Policy provides further guidance on the types of goods and services that may be paid for with brokerage commissions. The Proposed Policy also reinforces that it is an adviser’s responsibility to determine whether a good or service may be paid for with brokerage commissions, and to ensure that the goods and services benefit its clients.

Disclosure Requirements

An adviser will be required to provide certain disclosure to each of its clients with respect to soft dollar arrangements on an initial basis before the adviser starts conducting business with the client, and must make periodic disclosure on at least an annual basis. One objective of the disclosure requirement is to increase transparency regarding the brokerage commissions paid on a client’s behalf, by helping clients to better assess the uses of brokerage commissions by their advisers (and to ensure they are getting fair value). For existing accounts, an adviser must make the initial disclosure by the earlier of six months from the date the Proposed Instrument takes effect and the date the adviser makes its first periodic disclosure.

Adequate disclosure must be made of the arrangements entered into, including the names of the dealers and third parties that provide goods and services and the general type of the goods and services provided. Advisers will also be required to make specific disclosures with respect to the amounts of commissions paid, including disclosure to each client of the total brokerage commission (by security class) on behalf of the client and all clients, and will be required to separate trades between those involving only order execution services, trades where the adviser receives bundled services, and trades where third parties receive part of the commission. Estimates will need to be made of the brokerage commissions for each of the categories as a percentage of the total brokerage commissions paid (for the client and for all clients), as well as the weighted average brokerage commission per unit of security.

In addition, advisers will be required to maintain details of goods and services received for which payment was made with brokerage commissions for the most recent five years, and to make this information available to clients upon request.

The form of disclosure may be determined by the adviser according to the needs of its clients, but should be provided in conjunction with other initial and periodic disclosure relating to the management and performance of the account.

Timing

The Canadian Securities Administrators are seeking general comments, as well as responses to a number of specific questions, by October 19, 2006. It is currently contemplated that once the Proposed Instrument comes into effect, there will not be any transition period. It is expected that once the Proposed Instrument is finalized, many advisers will need to: (i) review their soft dollar practices; (ii) analyze whether the goods and services received comply with the Proposed Instrument; (iii) modify practices and/or arrangements; and (iv) arrange to compile and provide the additional information required to be disclosed to existing and new clients.

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The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.

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