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CSA Publishes Final Version of National Instrument Regarding the Use of Client Brokerage Commissions

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On October 6, 2009, the Canadian Securities Administrators (the “CSA”) released the final version of National Instrument 23-102 – Use of Client Brokerage Commissions (“NI 23-102”) and related Companion Policy 23-102CP. This instrument seeks to clarify when advisers (such as fund managers, portfolio managers or investment managers with discretionary authority) and securities dealers can exchange client brokerage commissions as payment for goods and services (commonly referred to as “soft dollar” arrangements).

NI 23-102 was approved by the Minister of Finance on November 27, 2009. It will come into force on June 30, 2010 (with a six-month transition period for advisers’ fulfillment of the disclosure obligations under Part 4 of NI 23-102). Existing soft dollar arrangement policies (Ontario Securities Commission Policy 1.9 (“OSC Policy 1.9”) and l’Autorité des marchés financiers Policy Statement Q-20) will cease to be in effect at that time.

General Rationale

When an adviser makes cash payments to a goods or services provider in exchange for goods or services that are purchased for use by or for the benefit of the adviser

(such as rent or office furniture), these “hard dollar” transactions are recorded as expenses of the adviser. When an adviser has the ability to direct its clients’ brokerage transactions and the related commission fees to a dealer in return for, directly or indirectly, the provision of goods or services that benefit the adviser (other than for permitted items, as discussed below), these “soft dollar” arrangements need to be evaluated in light of the dealer’s and the adviser’s duties to deal fairly, honestly, and in good faith with clients as well as in regard to the obligation to make reasonable efforts to achieve best execution and comply with any requirements pertaining to conflicts of interest. Securities regulators have decided that certain types of soft dollar arrangements are permissible and certain other types of soft dollar arrangements are not. Generally, and as addressed in more detail below, soft dollar arrangements are permissible where an adviser directs transactions to a dealer in exchange for which the dealer provides the adviser with brokerage and investment research services. It would be improper, for example, for an adviser to direct its clients’ brokerage transactions and the related commission fees to a securities dealer in return for that securities dealer agreeing to pay for the adviser’s rent, furniture or for

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any other goods or services not related to the investment decision and trade execution service that was required for the benefit of the adviser's client.

Highlights of the New Rules

NI 23-102 is intended to regulate soft dollar arrangements in circumstances where an adviser has discretion to make investment decisions on behalf of a client without his/her express consent. In these circumstances, client brokerage commissions can only be directed by an adviser (and accepted by a dealer) in return for (a) order execution goods and services; or (b) research goods and services.

Order execution goods and services includes both order execution and goods or services which are directly related to order execution. Determining whether or not a good or service is directly related to order execution is a matter of timing. To be directly related, goods or services must be provided or used between the time when an adviser makes an investment or trading decision and the time when settlement of the securities transaction has been irrevocably completed.

NI 23-302 defines research goods and services as:

- a) advice relating to the value of a security or the advisability of effecting a transaction in a security;
- b) an analysis, or report, concerning a security, portfolio strategy, issuer, industry, or an economic or political factor or trend; and
- c) a database, or software, to the extent that it supports goods or services referred to in paragraphs (a) and (b).

Differences Between NI 23-102 and OSC Policy 1.9

Principal Transactions

While OSC Policy 1.9 restricts soft dollar arrangements for trades conducted on either a principal or an agency basis, according to Companion Policy 23-102CP, the scope of NI 23-102 is limited to trades for which a brokerage commission is charged (or a similar transaction-based fee is charged which is plainly separate and identifiable from the amount paid for the security). Generally, this effectively means NI 23-102 is applicable only to agency trades and not principal trades.

However, Section 2.1(2) of Companion Policy 23-102CP states that in obtaining goods and services as a result of a principal transaction, an adviser has a duty to deal fairly, honestly, and in good faith with clients and to consider any applicable conflict of interest provisions such as those found in Section 13.4 of National Instrument 31-103 – Registration Requirements and Exemptions. As well, in its summary of comments and responses for the proposed NI 23-102, the CSA notes that it will continue to monitor the use of soft dollar arrangements for principal transactions and “will consider whether the Instrument should be amended in the future to bring such trading within the scope of the Instrument.”

Disclosure

Under OSC Policy 1.9, information about the research goods and services provided pursuant to a soft dollar arrangement, and the names of those providing those research goods and services, were only required to be provided to a beneficiary or trustee of an investment account upon request by that beneficiary or trustee. NI 23-102 will impose additional disclosure obligations. According to Part 4 of NI 23-102, advisers will have to provide

disclosure to a client before opening a client account or entering into a management contract (or similar agreement), which includes the following:

- a) a description of the process and factors considered in selecting a dealer;
- b) a description of the nature of potential soft dollar arrangements;
- c) a list of each type of research good or service that might be provided; and
- d) a description of the method by which the adviser makes a good faith determination that the client receives reasonable benefit from a soft dollar arrangement.

Advisers will also have to provide, at a minimum, annual disclosure to their clients which includes requirements (a), (b), and (d) above. The annual disclosure will also list each type of research good or service that has been provided and the names of any affiliated entity that provided any research good or service.

For more information on the subject of this bulletin, please contact the authors or any member of Fasken Martineau's Securities Group.

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