

Position Paper

Policy options for leveling the advisor compensation playing field



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1. Executive summary

Currently, Approved Persons governed by the Mutual Fund Dealer (MFD) Rules of the Canadian Investment Regulatory Organization (CIRO) are permitted to utilize an approach where the compensation they have earned through a sponsoring Dealer Member is paid to a party other than themselves¹. Approved Persons governed by the CIRO Investment Dealer and Partially Consolidated (IDPC) Rules, are not permitted to use such an approach.

CIRO has committed to developing a consistent approach to Approved Person compensation as a priority policy issue. This paper:

- analyses three such compensation approaches; an enhanced directed commission approach, an Incorporated Approved Person approach, and a registered corporation approach,
- discusses CIRO staff's preliminary position, which is to pursue an Incorporated Approved Person approach, and
- seeks public comment on the value of following policy options:
 - pure adoption of an Incorporated Approved Person approach²,
 - pure adoption of a registered corporation approach³, or
 - interim allowed use of an enhanced directed commission approach⁴ while pursuing the medium-term adoption of either:
 - an Incorporated Approved Person approach, or
 - a registered corporation approach.

Comments received on this paper will be considered by CIRO in the development of proposed rule amendments to harmonize acceptable Approved Person compensation approaches. The proposed rule amendments we develop will be subject to our normal publication for public comment and Canadian Securities Administrators (CSA) review and approval processes.

¹ MFD Rule 2.4.1(b) allows compensation earned by Approved Persons of sponsoring mutual fund dealers to be paid to an unregistered corporation except in Alberta and subject to certain conditions.

² Details of a proposed Incorporated Approved Person approach are provided in section 3.2 of this paper.

³ Details of a proposed registered corporation approach are provided in section 3.3 of this paper.

⁴ Details of a proposed enhanced directed commission approach are provided in section 3.1 of this paper.



Please note: While the taxation of compensation earned by Approved Persons for the activities they engage in for their sponsoring Dealer Member is the primary reason why allowing the use of a third compensation approach⁵ is being considered by CIRO in this position paper, compliance with applicable tax laws remains the responsibility of the Approved Person and their sponsoring Dealer Member. For the purposes of comparing the alternative compensation approaches considered in this paper, we expect that Approved Persons and their sponsoring Dealer Members will ensure compliance with applicable tax laws. For these reasons, the remainder of this paper focuses on possible amendments to CIRO requirements and securities legislation relating to the compensation alternatives under consideration and does not engage in a discussion or analysis of compliance with applicable tax laws.

2. Background

CIRO is committed to the protection of investors, providing efficient and consistent regulation, and building Canadians' trust in financial regulation and the people managing their investments. One of the ways CIRO intends to provide more efficient and consistent regulation is through pursuing rule amendments which improve the consistency of regulatory requirements applicable to investment dealers and mutual fund dealers (and their Approved Persons).

2.1 Possible compensation approaches

A current area of rule inconsistency is the approaches available to compensating Approved Persons. Possible approaches to a sponsoring Dealer Member compensating Approved Persons include making payments to:

- (i) an Approved Person pursuant to an employer/employee arrangement,
- (ii) an Approved Person pursuant to a principal/agent arrangement,
- (iii) a corporation owned by one or more Approved Persons in which activities⁶ are carried out within the corporation and the corporation:

⁵ A new third harmonized compensation approach in addition to the existing employer/employee and principal/agent arrangement approaches.

⁶ Throughout this position paper, the term:
(a) "activities" is used to refer to activities that are carried out within a personal corporation on the sponsoring Dealer Member's behalf,



- (a) is not required to be approved by CIRO or registered in the relevant CSA jurisdictions as long as the activities are limited to non-registerable activities (**directed commission approach**),
- (b) is required to be approved by CIRO to carry out these activities⁷ (**Incorporated Approved Person approach**), and
- (c) is required to be registered in the relevant CSA jurisdictions to carry out these activities^{8, 9} (**registered corporation approach**).

Approaches (i) and (ii) are permitted within both the IDPC Rules and MFD Rules. Approach (iii)(a) is permitted within the MFD Rules, subject to certain conditions, and is not permitted within the IDPC Rules. Approaches (iii)(b) and (iii)(c) are not currently permitted within either the IDPC Rules or the MFD Rules and are not permitted under securities legislation in effect in any province or territory¹⁰.

(b) “non-registerable activities” is used to refer to activities that do not require registration to be carried out and are carried out within a personal corporation on the sponsoring Dealer Member’s behalf, and

(c) “registerable activities” is used to refer to activities that require registration. Changes to securities legislation will be required for these activities to be carried out within a personal corporation on the sponsoring Dealer Member’s behalf.

⁷ Under this arrangement, the personal corporation would be approved by CIRO to engage in activities on behalf of the sponsoring dealer as an Incorporated Approved Person (a new non-individual Approved Person category) and CIRO would have the same jurisdiction over the Incorporated Approved Person (i.e., the personal corporation) as it currently has over individuals in all other Approved Person categories. The permissible activities under the Incorporated Approved Person arrangement would initially be limited to non-registerable activities. However, if securities legislation changes are implemented in one or more relevant jurisdictions to enable a corporation approved under this approach to engage in registerable activities, the full potential of this approach (i.e., allowing compensation from both non-registerable and registerable activities to be earned in the corporation) would be realized.

⁸ The permissible activities under a registered corporation arrangement might include both non-registerable and registerable activities. However, securities legislation changes would need to be implemented in one or more relevant jurisdictions to enable a corporation registered under this approach to engage in either non-registerable or registerable activities.

⁹ The registered corporation approach discussed in this paper is similar to the approach permitted in a number of provinces where a corporation is licensed to engage in the sale of life insurance products and permitted to receive the related sales commissions, including commissions received on insurance products that are similar to investment products such as segregated funds.

¹⁰ Provisions have been passed to permit approach (iii)(c) in Saskatchewan, but these provisions have not yet been proclaimed.



2.2 Compensation approach details and current rule requirements

A directed commission arrangement generally refers to an arrangement where an Approved Person requests their sponsoring Dealer Member to direct a portion of the commissions or fees they have earned, relating to non-registerable activities the corporation has carried out, to a personal corporation owned by the Approved Person (alone or with other Approved Persons and their family members).

The current CIRO rules applicable to mutual fund dealers and investment dealers currently take different approaches to directed commission arrangements. In short, the current:

- MFD Rules permit these arrangements except in Alberta¹¹, and
- IDPC Rules prohibit these arrangements except for arrangements outside of Alberta involving mutual funds only licensed Registered Representatives sponsored by firms registered as both an investment dealer and a mutual fund dealer (**dual-registered firms**)¹².

The carrying out of non-registerable and registerable activities through a corporation, pursuant to an Incorporated Approved Person arrangement is not currently permitted by either the MFD Rules¹³ or the IDPC Rules¹⁴. Under an Incorporated Approved Person arrangement:

¹¹ MFD Rule 2.4.1(a) requires remuneration to be paid by a mutual fund dealer (or its affiliates or related mutual fund dealers) directly to an Approved Person. However, MFDA Rule 2.4.1 (b) allows compensation to be paid to an unregistered corporation except in Alberta and subject to certain conditions.

¹² IDPC Rule subsection 2551(7) requires remuneration to be paid by an investment dealer (or its affiliates or related investment dealers) directly to an Approved Person. However, IDPC Rule subsection 2551(8) allows compensation earned by Registered Representatives dealing in mutual funds only outside of Alberta to be paid to an unregistered corporation subject to certain conditions. One of the conditions is that the sponsoring Dealer Member must be registered as both an investment dealer and a mutual fund dealer.

¹³ MFD Rule 1.1.1(c) specifies that the relationship that must be entered into between a person conducting securities related business on behalf of a dealer and the dealer must be either an employer/employee arrangement or a principal/agent arrangement.

¹⁴ IDPC Rule subsection 2302(1) specifies that the relationship that must be entered into between a person conducting securities related business on behalf of a dealer and the dealer must be either an employer/employee arrangement or a principal/agent arrangement. Further, IDPC Rule subsection 2302(2) specifically prohibits a dealer from allowing a corporation or other non-individual entity to conduct securities related business on behalf of the dealer.



- a personal corporation is set up by one or more Approved Persons to carry out activities (see footnote #7) relating to their work relationship with the sponsoring Dealer Member,
- the Approved Person's compensation is paid to the corporation for permitted business activities, and
- jurisdiction over the corporation and its activities and individual employees is obtained/maintained by the applicable regulators.

The carrying out of registerable activities through a registered corporation arrangement is also not currently permitted by either the MFD Rules or the IDPC Rules. A registered corporation arrangement is the same as an Incorporated Approved Person arrangement, with the exception that the corporation is registered with one or more CSA jurisdictions rather than approved as an Incorporated Approved Person by CIRO.

While directed commission arrangements have been used for decades, we have concerns about a lack of regulatory oversight over the activities Approved Persons carry out within the corporation to which commissions are directed under this arrangement, and whether the corporation is limiting its activities to non-registerable activities.

As the Incorporated Approved Person approach involves an Approved Person carrying out activities within a CIRO-approved corporation, having jurisdiction over the corporation would enable CIRO to more easily oversee the activities within and the owners of the corporation.

A similar result can be achieved under a registered corporation approach as under an Incorporated Approved Person approach. This is because this approach also involves regulators having jurisdiction over the corporation.

3. Analysis of compensation approach alternatives

In order to arrive at its preliminary position for your consideration and comment, CIRO staff have reviewed the following three compensation approaches:

- an enhanced directed commission approach,
- an Incorporated Approved Person approach, and
- a registered corporation approach.



3.1 Enhanced directed commission approach

3.1.1 Benefits and concerns associated with existing directed commission approach

A benefit of the existing directed commission approach permitted under the MFD Rules is that adopting this approach for use by all Approved Persons could be achieved through modification of CIRO rules alone.

Concerns with the existing approach are that there's insufficient transparency of the beneficial owners of and activities undertaken within the corporations who currently receive directed commission payments and it does not give CIRO the necessary jurisdiction to determine whether an Approved Person that uses this approach is ensuring that the corporation to which the commissions are directed is limiting its activities to non-registerable activities.

A proper framework for vetting of corporation owners and activities could address potential risks for investors.

3.1.2 Possible CIRO rule amendments to enhance existing directed commission approach

To address these concerns, CIRO rules could be amended to include provisions that would:

- place limitations on corporation ownership,
- place limitations on securities and other activities that may be conducted within the corporation, and
- require that the sponsoring Dealer Member verify compliance with these limitations before approving the directing of commissions to the corporation.

A likely ownership limitation would be to limit corporation ownership to Approved Persons and their immediate family and/or a family trust. A likely activities limitation might be to limit other corporation activities to financial services activities and, where appropriate, other activities approved by the sponsoring Dealer Member.

The requirement for a Dealer Member to verify compliance with these limitations before approving the directed commission arrangement would be very similar to the approach Dealer Members are currently



required to use when reviewing and approving Approved Person requests to engage in outside activities.

Adopting this enhanced directed commission approach as an acceptable approach to compensating all Approved Persons (in place of the current directed commission approach):

- would respond to industry requests to broaden the allowable use of a directed commission approach,
- would not require securities legislation changes to adopt, and
- would enhance investor protection, through the introduction of limitations to the ownership of and the activities conducted within the corporation and Dealer Member oversight over these limitations

but

- would not enable CIRO to determine whether an Approved Person that uses this approach is ensuring that the corporation to which the commissions are directed is limiting its activities to non-registerable activities.

A transition period for mutual fund dealing representatives transitioning from the existing directed commission approach requirements would also be necessary.

3.2 *Incorporated Approved Person approach*

3.2.1 *Benefits and concerns associated with Incorporated Approved Person approach*

Benefits of the Incorporated Approved Person approach are that:

- adopting this approach for use by all Approved Persons who only engage in non-registerable activities within the corporation could be achieved through modification of CIRO rules alone
- because CIRO could obtain regulatory jurisdiction over the corporation under this approach:
 - it would be easier for us to oversee the activities conducted within and the owners of the corporation
 - subject to necessary securities legislation amendments being implemented and requisite approval by provincial and territorial



securities regulators, Approved Persons could also be able to engage in registerable activities within the corporation

- investor protection would be further enhanced¹⁵, through the introduction of limitations to the ownership of and the activities conducted within the corporation and Dealer Member and CIRO oversight over these limitations
- it would hold Approved Persons equally accountable to:
 - the impacted clients
 - their sponsoring Dealer Member, and
 - CIRO

for the activities they conduct within the corporation in the same manner as for activities they might conduct as an employee or agent of the Dealer Member.

Concerns with this approach are that:

- the mechanism used by CIRO to obtain regulatory jurisdiction over the corporation will introduce additional requirements on the relevant individual Approved Persons, the sponsoring Dealer Member and CIRO registration staff, and
- securities legislation amendments would be required to allow Approved Persons to engage in registerable activities within the corporation under this approach¹⁶.

3.2.2 CIRO rule amendments required to adopt Incorporated Approved Person approach

CIRO rule amendments would be required to:

- permit the use of an Incorporated Approved Person approach as an acceptable approach to compensating Approved Persons,
- introduce a new non-individual Approved Person category (**Incorporated Approved Person**) whereby corporations approved

¹⁵ Investor protection would be further enhanced in comparison to the enhanced directed commission approach, as CIRO would also have oversight over the corporation.

¹⁶ A common concern/issue with all approaches (i.e., the current directed commission approach permitted under MFD Rule 2.4.1 and the three approaches analyzed within this position paper) is that securities legislation amendments would need to be enacted to allow Approved Persons to engage in and to be compensated for registerable activities within the corporation.



within this category are permitted to receive compensation under the Incorporated Approved Person approach,

- prescribe the requirements for a corporation to be approved as an Incorporated Approved Person, which would include:
 - prescriptive rule approval requirements (to be discussed in detail in section 3.2.4), and
 - a requirement to execute an agreement in a form acceptable to CIRO that details the rights and responsibilities of the sponsoring Dealer Member, the Incorporated Approved Person and the Approved Persons acting on their behalf under Incorporated Approved Person approach (**Incorporated Approved Person Agreement**).

3.2.3 Securities legislation amendments required to adopt Incorporated Approved Person approach

Securities legislation amendments would not be necessary to permit the use of the Incorporated Approved Person approach where the activities of the corporation are limited to non-registerable activities.

Securities legislation amendments would be necessary to permit the use of the Incorporated Approved Person approach where the activities of the corporation are to include registerable activities. This is because provincial and territorial securities acts do not permit non-registered individuals and corporations to engage in registerable activities¹⁷.

3.2.4 Incorporated Approved Person approval requirements

As part of the introduction of the Incorporated Approved Person approval category within CIRO's rules, the following approval requirements would need to be adopted and met by applicants:

¹⁷ As an example, subsection 25(1) of the Ontario Securities Act states the following:

“25 (1) Unless a person or company is exempt under Ontario securities law from the requirement to comply with this subsection, the person or company shall not engage in or hold himself, herself or itself out as engaging in the business of trading in securities unless the person or company

- (a) is registered in accordance with Ontario securities law as a dealer; or
 - (b) is a representative registered in accordance with Ontario securities law as a dealing representative of a registered dealer and is acting on behalf of the registered dealer.
- 2009, c. 18, Sched. 26, s. 4.”



- the corporation must be incorporated under the laws of Canada or a province or territory of Canada,
- the corporation must be a professional corporation in those jurisdictions in which becoming a professional corporation is available as an option,
- ownership of the corporation must be restricted to Approved Persons and their immediate family and/or a family trust,
- Approved Persons must be exclusively used within the corporation to conduct registerable activities on behalf of the sponsoring Dealer Member,
- all activities conducted within the corporation on behalf of the sponsoring Dealer Member must be conducted in the name or trade name of the sponsoring Dealer Member,
- activities conducted for others within the corporation would be limited to:
 - other licensed activities in the financial services industry,
 - other activities that have received advance sponsoring Dealer Member approval,
- the Approved Persons and the corporation must not hold client cash, securities, or other property, and
- an Incorporated Approved Person Agreement in a form acceptable to CIRO must be entered between the sponsoring Dealer Member, the Incorporated Approved Person (i.e., the corporation) and the Approved Persons acting on their behalf.

3.2.5 Incorporated Approved Person Agreement

The Incorporated Approved Person Agreement would include the following minimum terms:

- the Dealer Member, Incorporated Approved Person and Approved Persons acting on their behalf shall comply with applicable CIRO rules,
- the Dealer Member must supervise the Incorporated Approved Person, and its Approved Person employees and agents, and remain liable to clients and other third parties for acts and omissions of the Incorporated Approved Person,



- the Incorporated Approved Person must supervise its Approved Person employees and agents and remain liable to clients and other third parties for their acts and omissions,
- books and records in respect of the sponsoring Dealer Member's business that are in the possession of the Incorporated Approved Person remain records of the sponsoring Dealer Member and are available to the sponsoring Dealer Member and CIPF,
- the Incorporated Approved Person will obtain dealer advance approval for any changes in ownership, and
- any activities conducted by the Incorporated Approved Person that are not activities carried out on behalf of the sponsoring Dealer Member must be approved by the sponsoring Dealer Member.

3.3 Registered corporation approach

3.3.1 Benefits and concerns associated with registered corporation approach

Similar to the Incorporated Approved Person approach, benefits of the registered corporation approach are that because regulatory jurisdiction over the corporation would be obtained through corporation registration:

- it would be easier for CIPF to oversee the activities conducted within and the owners of the corporation
- Approved Persons would also be able to engage in registerable activities within the corporation
- investor protection may be further enhanced if clients are provided with statutory rights under securities legislation¹⁸
- investor protection may be further enhanced¹⁹ if legislative provisions were introduced to limit the ownership of and the activities conducted within the corporation and institute Dealer Member and CIPF/CSA oversight over these limitations

¹⁸ Investor protection may be further strengthened in comparison to the enhanced directed commission approach and the Incorporated Approved Person approach, if each jurisdiction introduces a legislative provision that requires the Dealer Member to have liability to clients for the activities of both the individual Approved Person and the registered corporation.

¹⁹ Investor protection would be further strengthened in comparison to the enhanced directed commission approach, as CIPF/CSA would also have oversight over the corporation.



- legislative provisions introduced by each jurisdiction may hold Approved Persons equally accountable to:
 - the impacted clients
 - CIRO, and
 - their sponsoring Dealer Member

for the activities they conduct within the registered corporation as for activities they might conduct as an employee or agent of the Dealer Member

Concerns with this approach are that:

- requiring registration to obtain regulatory jurisdiction over the corporation will introduce additional requirements on the relevant individual Approved Persons, the sponsoring dealer and CIRO and CSA registration staff
- securities legislation amendments/exemptions would be required to allow Approved Persons to engage in either non-registerable or registerable activities within the registered corporation under this approach^{20,21}.

3.3.2 *CIRO rule amendments required to adopt registered corporation approach*

CIRO rule amendments would be required to:

- permit the use of a registered corporation approach as an acceptable approach to compensating Approved Persons,
- mandate the execution of an agreement in a form acceptable to CIRO that details the rights and responsibilities of the sponsoring Dealer Member, the registered corporation and the Approved Persons acting on their behalf under the registered corporation approach.

²⁰ A common concern/issue with all approaches (i.e., the current directed commission approach permitted under MFD Rule 2.4.1 and the three approaches analyzed within this position paper) is that securities legislation amendments/exemptions would need to be enacted to allow Approved Persons to engage in and to be compensated for registerable activities within the corporation.

²¹ It should also be noted that there may be differences in the nature and timing of the securities legislation amendments/exemptions that may be considered by each provincial/territorial commission in order to ultimately permit an Approved Person's corporation to engage in and to be compensated for registerable activities, as well as local issues which are specific to each jurisdiction.



The agreement would include essentially the same provisions as those set out in section 3.2.5 above for the Incorporated Approved Person Agreement under the Incorporated Approved Person approach.

3.3.3 *Securities legislation amendments required to adopt registered corporation approach*

Legislation amendments would also be required to introduce and implement a new registration category (and associated registration requirements) for corporations subject to the registered corporation approach.

Legislative provisions introduced by each jurisdiction may entail eligibility requirements similar to those described in section 3.2.4 above for applicants to this new registration category. (see footnote 21)

3.4 *Process for the Dealer (and where applicable regulatory) approval*

Agreeing on efficient risk-based processes for the review and approval of arrangements entered into under the enhanced directed commission approach, the Incorporated Approved Person approach or the registered corporation approach is essential to ensuring that individual Approved Persons, sponsoring Dealer Member staff and CIRO and CSA staff resources are not needlessly overburdened.

Consistent with our overall risk-based regulatory approach, we suggest that the responsibility for determining that an arrangement qualifies under CIRO rules (and where applicable securities legislation) be shared by the sponsoring Dealer Member and CIRO staff (and where applicable CSA staff) in the following manner:

- the sponsoring dealer would be responsible for:
 - verifying the corporation's ownership structure,
 - obtaining background information on any owners that are not Approved Persons,
 - reviewing the business case submitted in support of permitting any owners that are not Approved Persons,
 - approving the ownership structure and the activities that will be conducted within the corporation in accordance with CIRO (and where applicable CSA) requirements,



- ensuring that any detrimental information relating to owners is reported to it and on to CIRO (and where applicable the CSA) on an ongoing and prompt basis, and
- where applicable, providing evidence of the sponsoring dealer's approval of the Incorporated Approved Person application.
- CIRO (and where applicable the CSA) would be informed of the sponsoring Dealer Member approval of the application for approval or registration and CIRO will rely on this approval to automatically approve the application. Records relating to all such automatic approvals will be retained by the sponsoring Dealer Member and will be subject to periodic inspection by CIRO examination staff.

A transition period for mutual fund dealing representatives transitioning from the existing directed commission approach requirements would also be necessary.

4. Transition period

Should CIRO and the CSA proceed with either the enhanced directed commission approach, the Incorporated Approved Person approach, or the registered corporation approach, we would recommend a two-year transition period for mutual fund dealing representatives to allow them time to comply with the new requirements. However, all Approved Persons would have the option of availing themselves of the relief available under the new requirements immediately once the revised CIRO rules (and, where applicable, securities legislation) are approved and implemented.

5. Relevant industry comments

Industry comments on this matter received as part of the public comments received on CSA consultation Paper 25-402, *Consultation on the Self-Regulatory Organization Framework*, suggested expanding the MFD Rules directed commission approach to all investment dealer and mutual fund dealer Approved Persons to address regulatory arbitrage.

Some commenters also were of the view that the Registered Corporation approach is the most appropriate approach but raised concerns about how quickly the CSA would be able to make legislative changes.

6. CIRO staff preliminary position



CIRO staff are of the preliminary view that the Incorporated Approved Person approach is the preferred approach as:

- it provides Approved Persons with the same ability to engage in non-registerable activities within the corporation as under the directed commission approaches (both existing and enhanced), through modification of CIRO rules alone
- unlike the directed commission approaches (both existing and enhanced):
 - it enhances investor protection because it provides CIRO with clear jurisdiction over the actions and activities undertaken by the corporation, and
 - it provides Approved Persons with the possibility of being able to engage in registerable activities within the corporation, as securities legislation in each provincial and territorial jurisdiction is amended to allow for it
- it introduces less incremental burden on the relevant individual Approved Persons, the sponsoring Dealer Member and CIRO and CSA registration staff than would be introduced under the registered corporation approach.

7. Specific questions for response

To assist us in making our final assessment of the policy options set out in this paper, we would appreciate it if you could include within any comments you provide on this paper responses to the questions set out below.

7.1 Question #1

This paper discusses compensation approaches that could be made available for use to all CIRO Approved Persons. Which of the following rulemaking options do you prefer that CIRO pursue and why:

- pure adoption of an Incorporated Approved Person approach,
- pure adoption of a registered corporation approach, or
- interim allowed use of an enhanced directed commission approach while pursuing over the medium-term the adoption of either:
 - an Incorporated Approved Person approach, or
 - a registered corporation approach.

7.2 Question #2



Are there other requirements not discussed in this paper that CIRO should include within any rule amendments it proposes relating to acceptable compensation approaches?

7.3 Question #3

Are there other matters not discussed in this paper that CIRO should consider when assessing which policy option to pursue?