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Investment Industry Regulatory Organization of Canada
Organisme canadien de réglementation du commerce des valeurs mobilières

IIROC NOTICE

Rules Notice
Request for Comments
Dealer Member Rules

Please distribute internally to:

Legal and Compliance
Registration
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15-0260
November 25, 2015

IIROC White Paper

The Public Policy Implications of Changes to Rules Regarding Proficiency Upgrade Requirements and Directed Commissions on the IIROC Platform

Summary and request for comments

IIROC is considering ways in which we can make the delivery of securities regulation in Canada more efficient by reducing regulatory overlaps and harmonizing our requirements and standards with those on other regulatory platforms, while pursuing the public interest and maintaining or enhancing investor choice and investor protection.

As a result, IIROC is seeking comment on an illustrative proposal that would allow firms and individuals to conduct, under IIROC's regulatory oversight, a business that is limited to mutual funds and exchange-traded funds.

Under this approach, IIROC would:

1. Eliminate its current requirement for firms and individuals to be qualified to offer a full range of investment products, and instead allow firms and individuals to offer only

mutual funds and exchange-traded funds (with appropriate adjustments for the relative risk of such firms and individuals to IIROC's proficiency, supervisory and oversight requirements); and

2. Allow all firms and individuals under IIROC's regulatory oversight to take advantage of what is referred to as "directed commissions".

This paper (the **White Paper**) provides detailed background to these concepts and this illustrative proposal, and identifies a number of policy considerations that stakeholders may wish to take into account in answering the following questions:

1. Would you support this proposal as being in the public interest?

2. What impact would the adoption of this proposal have on each of the following:

    a. investors;

    b. registered firms;

    c. registered individuals; and

    d. Canadian regulatory and financial industry structure,

    and how should these impacts be addressed?

We are publishing this illustrative proposal as a possible first step in what, if pursued, would be an extensive consultative process to consider the initiatives described in this White Paper. This White Paper raises many complex and inter-related elements that have broad policy implications and will require extensive policy discussions.

We have not consulted with the Canadian Securities Administrators (**CSA**) in developing this proposal, nor has the CSA expressed any view concerning whether or not any element of the proposal has merit, or whether or not it is in the public interest either in the short or long term. The review by the CSA would not necessarily be limited to the illustrative proposal as presented by IIROC in this White Paper, or as may be presented in the future. Any concrete rule changes that follow from this process would be subject to public comment and to CSA approval, and consultation with all affected stakeholders.

Comments and submissions

Comments on this White Paper are requested by March 31, 2016 and may be delivered by mail, fax or email to:

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Please note that all comment letters submitted will be made publicly available on the IIROC website – www.iiroc.ca – under the heading "Rule Book – IIROC Dealer Member Rules – Proposed Policy".

Please refer your questions to:

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Introduction

As noted above, IIROC is considering ways in which we can make the delivery of securities regulation in Canada more efficient by reducing regulatory overlaps and harmonizing our requirements and standards with those on other regulatory platforms, while pursuing the public interest and maintaining or enhancing investor choice and investor protection. To this end, IIROC is considering the proficiency upgrade requirement (defined in section 2.1) under current IIROC Dealer Member Rules, the related issue of directed commissions (defined in section 2.2), and the appropriateness of these on the IIROC platform.

The proficiency upgrade requirement was the subject of an exemption request IIROC received from an IIROC Dealer (the **Applicant**) in 2013. IIROC initially granted the Applicant an exemption from the proficiency upgrade requirement but subsequently withdrew it, with the consent of the Applicant, in order to allow further consideration of the broader regulatory and public policy issues the application raised. These broader issues led the CSA to ask IIROC and the Mutual Fund Dealers Association of Canada (**MFDA)** to consult with their respective members on whether investment dealers should be permitted to employ mutual fund restricted dealing representatives.

IIROC surveyed (the **Survey**) its Dealers (discussed in more detail under section 2.4) on the questions raised by the CSA. (During this time, IIROC also received an application from an IIROC Dealer seeking permission to use directed commissions.) The results of the Survey led us to seek broader input on the impact the elimination of the proficiency upgrade requirement and the adoption of a directed commission structure on the IIROC platform would have on

investors, mutual fund distribution channels, registered firms and individuals, and on the securities regulatory structure in Canada.

This White Paper is intended to give all stakeholders the opportunity to provide their views on these issues and their implications for Canadian securities regulatory and financial industry structure to assist us and others in considering and informing any future policy development.

1. Implications of eliminating the proficiency upgrade requirement and adopting a directed commission structure on the IIROC platform

The results of the Survey highlighted that, for many registered firms and individuals, eliminating the proficiency upgrade requirement on the IIROC platform is of limited interest unless directed commissions are also allowed. IIROC's current regulatory regime does not provide for directed commissions; however, directed commissions are allowed under MFDA rules, and are widely used in the mutual fund industry.

This illustrative proposal removes two barriers to entry – the inability to direct commissions and the requirement to upgrade proficiency – for firms and individuals who wish to be regulated by IIROC but restrict their activities to mutual funds and exchange-traded funds.[1]

The proposal would open up the opportunity for not only mutual fund dealing representatives to move to the IIROC platform to carry on their mutual fund sales activities, but also for IIROC to consider the desirability of a new category of approval for mutual-fund-only firms and individuals.

As discussed above, the creation of a new category of approval and the other changes discussed in this White Paper would notably require discussion of broader policy issues, and the approval of existing members of IIROC. It would also require consideration to be given to the application of IIROC's Dealer Member Rules to a mutual-fund-only firm. For example, a mutual-fund-only firm which is conducting more limited activities than a full-service firm and does not hold any client assets presents a different risk profile than a self-clearing full-service investment dealer.

We would also have to review IIROC's fee models and cost structure to ensure that both reflected the circumstances and regulatory effort associated with the more limited activities of such firms and individuals.

[1] For ease of reference, these two products are referred to as "mutual funds".

2. Background to the issues

2.1 Proficiency upgrade requirement[2]

IIROC Dealer Member Rules require (the **proficiency upgrade requirement**) registered representatives (**RR**) and investment representatives (**IR**) of an IIROC Dealer who have only the mutual fund dealer representative proficiency qualifications to

(i) upgrade their proficiency to investment dealer representative qualifications within 270 days of approval as a RR or an IR; and
(ii) complete the applicable training program within 18 months,

after which they become a full RR or IR and able to trade and/or advise in a broader range of securities. During the 270-day period, the RR or IR is restricted to trading in securities of mutual funds only. In the event a representative does not complete the proficiency upgrade requirement within the prescribed time, the representative's registration is automatically suspended.

One of the main differences between the minimum proficiency requirements for RRs and IRs under IIROC Dealer Member Rules and the minimum proficiency requirements for mutual fund dealing representatives under MFDA rules is the requirement under the IIROC Dealer Member Rules for the successful completion of The Conduct and Practices Handbook Course[3] which isn't required under the MFDA rules. The Conduct and Practices Handbook Course addresses ethics and conduct matters, and provides certain regulatory foundational knowledge.

2.2 Directed commission[4]

For purposes of this White Paper, what we mean by *directed commission* is the ability of a dealing representative to request his sponsoring dealer to pay all or a portion of the commissions earned by him directly to a personal corporation. The personal corporation may provide administrative services to the dealing representative, and may carry on activities that do not require registration under securities legislation (such as selling insurance).

Directed commission is distinct from the idea of an *incorporated salesperson*, which is the ability of an individual to carry on registrable activities (e.g., trading or advising activities) through a corporation that is itself registered under securities legislation. Generally, incorporated salespersons are not permitted for any dealers (investment or mutual fund) under the current

[2] Details on the regulatory history of the proficiency upgrade requirement are set out in Appendix A.

[3] Administered by Moody's Analytics Global Education (Canada) Inc., commonly referred to as the Canadian Securities Institute or CSI.

[4] See Appendix B for additional detail on the issue of directed commissions in Canada.

securities regulatory regime in Canada. IIROC Dealer Member Rule 39.3 expressly prohibits incorporated salespersons[5].

IIROC Dealer Member Rules do not provide for a directed commission model but rather require that dealing representatives receive compensation directly from their sponsoring firm[6] in both an employer-employee relationship and an agent-principal relationship[7] between a firm and its dealing representatives.

If IIROC were to allow directed commissions, only firms and individuals in an agent-principal relationship would be able to make use of them, which may cause individuals who are in an employer-employee relationship to ask to move to an agent-principal relationship.

As mentioned earlier, the majority of CSA jurisdictions[8] have approved the MFDA rule[9] permitting the payment of commissions to unregistered corporations. The MFDA rule incorporates a number of conditions, including the requirement that the mutual fund dealer, its dealing representative and the dealing representative's unregistered corporation enter into a written agreement which confirms, among other things, that (i) the arrangement does not in any way affect the duties, obligations or liability of the dealer or the dealing representative, (ii) the dealer is to supervise the dealing representative and the unregistered corporation to ensure compliance with MFDA requirements, and (iii) the dealing representative and the unregistered corporation must provide full access to all books and records to the dealer.

Any IIROC rule permitting directed commissions would be subject to conditions at least as protective of investors, and would possibly include additional conditions.

In light of the differences between the current IIROC regime and the MFDA regime with respect to the proficiency upgrade requirement and directed commissions, IIROC Dealers that wish to include mutual fund dealing representatives within their corporate group currently are required to either:

(i) ensure that the mutual fund dealing representatives satisfy the proficiency upgrade requirement and do not operate under a directed commission model, or
(ii) cause a separate legal entity (often an affiliate of the investment dealer) that is registered as a mutual fund dealer to employ such representatives.

[5] See Appendix C for additional detail on the issue of incorporated salespersons in Canada.

[6] For example, see IIROC Dealer Member Rule 18.15.

[7] These requirements are set out in IIROC Dealer Member Rule 39.3.

[8] See Appendix B.

[9] MFDA Rule 2.4.1(b) *Payment of Commissions to Unregistered Corporations*.

2.3 The proficiency upgrade requirement exemption request

As mentioned above, IIROC received an application for an exemption from the proficiency upgrade requirement, which raised issues that have led to the publishing of this White Paper. The Applicant applied for the exemption in respect of its particular business model on the basis that there would be:

(i) **No reduction in investor protection**: all dealing representatives (restricted and non-restricted) would be subject to IIROC oversight. In addition, technology and compliance systems would ensure that a restricted dealing representative's trading activities are limited to mutual fund securities only.
(ii) **Improved client service:** a client would have better access to the appropriate type of representatives, services and products as the client's investing needs mature and change over time (e.g., moving from mutual fund investments only to investing in a broader range of securities) without having to move to a different firm.
(iii) **Cost efficiencies for industry:** a duplicative, two-dealer (IIROC and MFDA) structure imposes a substantial burden on registered firms in terms of legal, regulatory, tax, operations, compliance and technology costs which could be reduced by consolidating businesses onto one platform.

After due consideration of the public interest, the IIROC Board granted the requested exemption[10] which would allow the Applicant to move its existing mutual fund dealing business and representatives onto the IIROC platform without satisfying the proficiency upgrade requirement, subject to conditions.

IIROC concluded that the exemption was not prejudicial to the interests of IIROC Dealers, their clients or the public because the trading activities that the mutual fund restricted dealing representatives would carry on under the IIROC platform would be the same as, and restricted to, the activities they carried on under the MFDA platform, these representatives would have higher proficiency levels on the IIROC platform than they had on the MFDA platform, and these representatives would be subject to an equally robust regulatory oversight regime.

To address IIROC-specific issues, the IIROC exemption required that any dealing representatives exempted from the proficiency upgrade requirement be subject to:

(i) a restriction on their business to trading in mutual funds only (mutual fund restricted dealing representatives could upgrade their proficiency at any time to the investment dealer representative proficiency which would permit them to trade in a broader range of investment products); and

[10] The IIROC Board may exempt an IIROC Dealer from the requirements of any provision of the IIROC Dealer Member Rules where the IIROC Board is satisfied that to do so would not be prejudicial to the interests of IIROC Dealer Members, their clients or the public. See IIROC Dealer Member Rule 17.15.

(ii) the requirement to complete an additional training program within 90 days of registration with IIROC. In granting the exemption, IIROC believed that additional training, focused on ethics, conduct and other IIROC-specific information that was relevant to a restricted mutual fund dealing registration on the IIROC platform, was required to address differences between training under the IIROC platform and training under the MFDA platform.

In addition, margin lending would not be permitted for the client accounts in respect of which mutual fund restricted dealing representatives were dealing or advising. This condition was considered appropriate since, unlike the IIROC platform where a full dealing representative's proficiencies include education regarding margin lending, lending is not available on the MFDA platform so mutual fund dealing representatives may not have any training or experience with respect to margin lending.

Finally, the Applicant was required to provide IIROC with a detailed plan setting out the structure of the proposed reorganization. This plan would be subject to approval by IIROC staff and/or an IIROC District Council, as applicable, and IIROC also contemplated that the applicable CSA jurisdictions would have a role in reviewing the reorganization.

2.4 IIROC Survey

Following the granting of the proficiency upgrade requirement exemption, the CSA asked IIROC and the MFDA to consult with their respective members on whether investment dealers should be permitted to employ mutual fund restricted dealing representatives. In particular, the CSA asked IIROC and the MFDA to obtain their respective members' views on the interests of IIROC and MFDA members that are in favour of the granting of (or alternatively the refusal of) an exemption from the proficiency upgrade requirement and what other alternatives would best support the interests of all IIROC and MFDA members

To address the CSA's questions, IIROC worked with the MFDA to agree on surveys that were substantially equivalent in form and content. The IIROC Survey[11] took the respondent through demographic questions to provide context to the substantive responses. The Survey asked respondents:

(i) if they would seek relief from the upgrade requirement;
(ii) to explain why they would or would not seek relief and, if interested, how soon they might do so;
(iii) to enumerate positive and negative implications of permitting mutual fund restricted representatives to operate on the IIROC platform on the respondent, its approved persons, and its clients;

[11] 160 IIROC Dealer Members were surveyed and 41 responded to the Survey. There was a high response rate for dual-platform (IIROC and MFDA) firms. 15 of the 41 responding Dealer Members would pursue relief from the proficiency upgrade requirement if given the opportunity. Review of the comments of respondents indicates that other Dealer Members support the relief, but are not certain if they themselves would seek it.

(iv) if such registration of mutual fund restricted representatives should be done through a rule amendment or exemptive relief process; and
(v) if there are alternatives to the granting of relief that would support the interests of investors, IIROC Dealers and approved persons.

With respect to the qualitative input provided by IIROC Dealers in response to the IIROC Survey, the following are some of the key findings:

(i) the reasons that IIROC Dealers would take advantage of the relief are increased flexibility, operational efficiencies, reduced costs, and an enhanced client experience;
(ii) some IIROC Dealers would require more information and would have to perform more analysis before deciding whether or not they would take advantage of the relief;
(iii) with respect to the positive and negative implications for firms, registered individuals and clients, most respondents focused on the pros and cons of the relief from their own perspective, as opposed to commenting on the impact on the industry and investors as a whole; those who did concentrate on industry impacts generally highlighted the negative implications for firms, which included increased competition for MFDA members from IIROC Dealers, potentially leading to fewer mutual-fund-only firms and the loss of the MFDA platform;
(iv) respondents were strongly in favour of any relief from the proficiency upgrade requirement being provided by way of a rule amendment as opposed to exemptive relief, in order to ensure consistency, a level playing field and that the change would be accompanied by a transparent consultation process; and
(v) the principal alternative to granting the relief identified by respondents was an IIROC-MFDA merger although some respondents also identified the differences between the IIROC and MFDA platforms (e.g. the use of directed commission structure) as an area for harmonization.

IIROC reported on the Survey results to the IIROC Dealers who participated in the Survey. In its report, IIROC signaled that it would be soliciting additional feedback from a broader audience on issues raised in the Survey. This White Paper is the next step in seeking the additional feedback.

3. Discussion of regulatory and industry issues with the elimination of the proficiency upgrade requirement and directed commissions

There are a number of regulatory and industry considerations associated with our illustrative proposal. We will discuss these issues in the context of three categories – investor protection, IIROC Dealers, and dealing representatives.

3.1 Investor protection issues

IIROC Dealers who responded to the Survey identified the following positive and negative implications for investors that may arise from the elimination of the proficiency upgrade requirement.

Positive implications	**Negative implications**
• one-stop shopping • consolidated reporting • increased range of investment products • ability to maintain relationships with dealing representatives • benefits of enhanced proficiency for mutual fund dealing representatives on IIROC platform • benefits of firms investing cost savings in enhancing the client experience • increased clarity of dealing with one firm, one regulator and one complaint process • CIPF is more established than the MFDA IPC • mutual fund investors in Québec will gain access to CIPF coverage	• reduced industry competition • potential confusion as to which products and services can be offered by a mutual fund restricted dealing representative • risk of mutual fund restricted dealing representatives selling products for which they are not registered • transition issues • potential for increased costs • loss of aggregated CIPF and MFDA IPC coverage if mutual fund restricted dealing representative moves to the IIROC platform (i.e. if a client has an account with an MFDA firm and a separate account with an IIROC firm, the client has the benefit of both CIPF and MFDA IPC coverage)

As a public interest regulator, investor protection is the most important aspect of IIROC's regulatory mandate. The elimination of the proficiency upgrade requirement must therefore be looked at, first and foremost, through that lens. As discussed above, IIROC considered investor protection issues very carefully in the context of the exemption request it received and determined that, in that case, an exemption from the proficiency upgrade requirement with the conditions as discussed above was not prejudicial to the public interest.

3.2 IIROC Dealer issues

The following chart sets out some of the positive and negative implications that IIROC Dealers identified in their responses to the Survey for firms that take advantage of an exemption from the proficiency upgrade requirement.

Positive implications	**Negative implications**
• increased flexibility in transferring clients	• increased complexity associated with

Positive implications	Negative implications
and registered individuals • facilitating succession planning for mutual fund dealing representatives, by allowing them to transition their business to an investment dealer dealing representative • streamlined corporate structure, operational efficiencies (e.g., compliance structures) and reduced costs realized by operating on one platform • opportunity for business growth • opportunity to enhance the client experience by the client being able to deal with one firm, and by investing savings from operational efficiencies in enhancing the client experience • opportunity to enhance the experience and proficiency of registered individuals • greater customer clarity regarding the complaints process	compliance oversight of mutual fund restricted dealing representatives • burden of additional training for mutual fund restricted dealing representatives • risk of mutual fund restricted dealing representatives selling products for which they are not registered • transition issues and costs associated with moving mutual fund dealing representatives to the IIROC platform • IIROC requirements that are incompatible with the mutual fund business model (e.g., use of directed commission structure) • increased costs (e.g., higher capital requirements on the IIROC platform; increased membership fees payable by Québec firms to IIROC compared to fees currently paid to the AMF)

From an industry perspective, while there are many benefits identified by industry participants that arise from eliminating the proficiency upgrade requirement, there are also factors that could make it unattractive to others.

A number of IIROC Dealers with MFDA affiliates have strong branding on both the IIROC and MFDA sides of their business. Some MFDA affiliates of IIROC Dealers hold multiple registrations including scholarship plan dealer, portfolio manager, exempt market dealer, investment fund manager and commodity trading manager registration. Many corporate groups have diverse business, legal and tax structures that underlie their corporate structures. This diversity may result in limited interest in the elimination of the proficiency upgrade requirement for some IIROC Dealers.

Generally under the current Canadian securities regulatory regime, it is the role of IIROC to regulate full-service dealers and the role of the MFDA to regulate those conducting mutual fund sales exclusively. The elimination of the proficiency upgrade requirement would eliminate a barrier to entry for mutual fund dealing representatives who would like to work on an IIROC platform and for IIROC Dealers who would like to develop or expand their mutual fund service offerings. Elimination of the proficiency upgrade requirement may cause increased competition for MFDA members from IIROC Dealers, resulting in:

(i) fewer mutual-fund-only firms on the MFDA platform, potentially leading, as noted by Survey respondents, to the the MFDA becoming less economically viable; and
(ii) mutual fund dealing representatives whose sponsoring firms take advantage of the relief, choosing to exit the business rather than go onto the IIROC platform and be subject to IIROC requirements.

3.3 Dealing representative issues

The following chart sets out some of the positive and negative implications that were cited by IIROC Dealers in the Survey results for dealing representatives if they took advantage of an exemption from the proficiency upgrade requirement.

Positive implications	**Negative implications**
• greater employment opportunities for mutual fund dealing representatives • ease of transition to the IIROC platform • greater flexibility and opportunity for personal and business development • ability to add more value for clients • operational efficiencies and reduced costs • some compliance responsibilities would be shifted from advisors to firms	• increased and "unfair" competition • increased costs and transition issues associated with moving to the IIROC platform • possibility for investor confusion over the difference in expertise between full dealing representatives and a mutual fund restricted dealing representatives • requirement to increase proficiency to move to IIROC platform and comply with continuing education requirements • inability to use directed commission structure

The proficiency standard for mutual fund dealing representatives is mandated by the CSA and the MFDA, and these standards are consistent with IIROC's existing requirements for representatives conducting business restricted to mutual funds, prior to completing the proficiency upgrading requirement; however, the proficiency standard does not include ethics training or IIROC-specific information that is equivalent to IIROC's requirements.

In addition, the mutual fund dealing proficiency standard does not include margin training since mutual fund dealers are not permitted to provide margin. From an investor protection perspective, margin lending should only be permitted (subject to applicable suitability obligations) for client accounts that are serviced by appropriately proficient dealing representatives and so should not be permitted for client accounts in respect of which mutual fund restricted dealing representatives are dealing since, without meeting the proficiency upgrade requirement, their proficiency would not include education regarding margin lending.

Considerations:

1. Do you think there are other positive and/or negative implications of eliminating the proficiency upgrade requirement on investors, dealers and registered individuals in addition to those discussed above? If so, please describe.

2. If the proficiency upgrade requirement was eliminated, some additional proficiency requirements over and above the current MFDA requirements for a mutual fund restricted dealing representative could still likely be required. If so, what issues, if any, would additional proficiency requirements raise?

3. What conditions would you consider appropriate to place on a mutual fund restricted dealing representative on the IIROC platform to ensure that investor protection was not compromised?

3.4 Regulatory and industry issues arising with respect to directed commissions

The directed commission structure has been consistently used for more than 20 years in the mutual fund industry. Advocates in favour of a directed commission structure cite a number of benefits to such a structure including:

(i) providing a more tax-efficient structure to manage business tax flow and disbursements;
(ii) enhancing staff recruitment and retention;
(iii) facilitating succession planning for advisors; and
(iv) enhancing the client experience.

The introduction of a directed commission structure under the IIROC platform would require amendments to be made to IIROC rules to ensure that the relationship between an IIROC Dealer, its dealing representative, and the dealing representative's unregistered corporation satisfies all of the regulatory safeguards that are in the interests of the public, IIROC Dealers and dealing representatives – e.g., ensuring that an IIROC Dealer remains liable to its clients for the actions of its dealing representatives and that conflicts of interest are managed appropriately.

Taxation issues

The tax status of individual registrants who use a directed commission structure is unclear. As discussed, there is a requirement under securities legislation in Canada that all registrable activities be conducted by appropriately registered individuals. As well, there is a requirement in tax legislation that a corporation can only declare income that it earns from activities that the corporation undertakes. A potential tax liability could arise if the payment of the commission

was not reported and withholding tax and source deductions obligations fulfilled in accordance with tax legislation.

Considerations:

1. Is a directed commission structure appropriate under the IIROC platform? If so, what conditions, if any, would be appropriate for a directed commission structure?

3.5 Potential issues specific to the Québec regulatory framework

The potential issues derived from a new IIROC category of approval for mutual-fund-only firms and individuals that are specific to the Québec regulatory framework are summarized below.

Chambre de la sécurité financière

Under section 312 of *An Act respecting the distribution of financial products and services* (the **Distribution Act**), representatives of firms registered in the category of mutual fund dealer are required to be members of the Chambre de la sécurité financière (**CSF**).

A new IIROC category of approval for mutual-fund-only firms and individuals could require legislative changes to allow individuals to cease being dealing representatives of a mutual fund dealer and become dealing representatives of an IIROC Dealer while continuing to be restricted to mutual funds business which would mean, these representatives could no longer be required to be members of the CSF. Therefore, a new IIROC category of approval for mutual-fund-only firms and individuals might have an impact on CSF membership.

Fonds d'indemnisation des services financiers (financial services compensation fund)

Under section 148.2 of the *Securities Act* (Québec), the provisions of the Distribution Act pertaining to the financial services compensation fund (the **Compensation Fund**) apply to firms registered in the category of mutual fund dealer. For mutual fund dealers, the Compensation Fund is financed on the basis of the number of representatives sponsored by firms registered in the category of mutual fund dealer. Therefore, a new IIROC category of approval for mutual-fund-only firms and individuals might have an impact on the Compensation Fund, and such impact would be proportional to the decrease in the number of individuals registered in the category of dealing representative of a mutual fund dealer. A significant decline in the number of individuals registered in the category of dealing representative of a mutual fund dealer could result in a decrease in income for the Compensation Fund, and consequently a re-evaluation of the fees payable to the Compensation Fund.

4. Next Steps

IIROC is very interested in receiving your input on the issues and questions set out in this White Paper. We will review the feedback we receive to assist us in considering the regulatory responses available to us which could include:

(i) Maintaining the status quo of IIROC's regulatory regime (i.e. no directed commission and continuation of the proficiency upgrade requirement).
(ii) Eliminating the proficiency upgrade requirement only.
(iii) Allowing a directed commission structure on the IIROC platform.
(iv) Eliminating the proficiency upgrade requirement and allowing a directed commission structure on the IIROC platform.

Upon completion of the comment period and consideration of the comments received, we will determine if further consultation with stakeholders, including other regulators, is required.

Appendix A

Regulatory History of the Proficiency Upgrade Requirement

Ontario securities regulations and Ontario Securities Commission (**OSC**) rules (along with corresponding rules in New Brunswick) in effect prior to the formation of the MFDA precluded dealing representatives of a mutual fund dealer from being registered as dealing representatives of an investment dealer. The result of this regulatory approach was that an investment dealer could only employ dealing representatives who met the proficiency requirements applicable to trading or advising in the type of securities that the investment dealer was permitted to trade or in respect of which it could advise.

The OSC amended its requirements on August 17, 2000, following a four-year consultation period, to permit dealing representatives who were restricted to trading in mutual fund securities only (**mutual fund restricted dealing representatives**) to be employed by investment dealers but only for a period of 270 days, during which time the mutual fund restricted dealing representatives are required to complete the necessary proficiency requirements applicable to an investment dealer representative.

In addition to the above restrictions, the Ontario securities regulations also limited the number of mutual fund restricted dealing representatives which could be employed by an investment dealer at any one time to the lesser of 100 and 5% of the total number of dealing representatives. This restriction was removed in 2007. At the time, the OSC commented as follows:

> "*The Commission has considered the suggestion to remove the 270 Day Requirement and decided not to do so at this time. The purpose of the temporary status of 'restricted representative' is to facilitate the transition of newly hired IDA salespersons who already have qualifications appropriate to the sale of mutual funds into fully-qualified IDA (Investment Dealers Association) salespersons. The effect of combining [the removal of the cap on the number of mutual-fund-only salespeople permitted at full service dealerships] with the removal of the 270 Day Requirement would be to change the purpose of having restricted representatives at IDA members. It would become possible for individuals hired as restricted representatives to remain so indefinitely, allowing IDA members to have unlimited numbers of representatives qualified only to deal in mutual funds. However, as our securities regulatory system is presently structured, it is the role of the MFDA to act as the self-regulatory organization (the SRO) for firms and individuals whose dealer activities are limited to sales of mutual funds. The consequences of removing the 270 Day Requirement would be to permit a business model that would be inconsistent with the design of the existing regulatory system. Also, if a sufficient number of the MFDA's larger members were to transfer their operations to IDA*

affiliates, the ongoing viability of the MFDA could be undermined. We therefore believe that it is appropriate to maintain the 270 Day Requirement until such time as the role of these SROs in our regulatory system is re-evaluated." (Notice of Amendment to OSC Rule 31-502 Proficiency Requirements for Registrants, March 9, 2007)."

As part of the national registration reform project, the Ontario and New Brunswick rules were repealed upon the adoption of National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (**NI 31-103**) on September 28, 2009. NI 31-103 does not include the proficiency upgrade requirement as such requirement was added to the IIROC Dealer Member Rules on the same day that NI 31-103 became effective.

Appendix B

Background on Directed Commissions

The regulatory/industry debate in Canada about directed commissions and incorporated salespersons has been going on for well over 15 years. In 1999, the CSA released CSA Notice 33-304 commonly known as the *Distribution Structures Paper* (subsequently repealed by the CSA in 2009) which discussed the regulatory issues that had arisen due to changes that had occurred in the manner in which securities firms structure their businesses to facilitate the commercial provision of securities trading and advising services to the public. The *Distribution Structures Paper* emphasized that an individual salesperson could not carry on registrable activities through an unregistered company – however, certain service arrangements between dealers and unregistered companies were deemed to be acceptable. The CSA outlined their regulatory concerns related to the involvement of unregistered corporations in securities trading activities – i.e. ensuring effective supervision, legal responsibility to clients, regulator's access to books and records and conflicts of interest – without discussing in any detail the regulatory concerns around the practice of directed commissions.

A bright light was shone on directed commissions at the time the MFDA was established. Originally, the MFDA rules (specifically MFDA Rule 2.4.1) prohibited payments of commission to anyone other than the individual registered dealing representative. The introduction of this prohibition caused intensive lobbying from the mutual fund industry against the prohibition (the directed commission model was already a common practice in that industry by that time) which resulted in the suspension of MFDA Rule 2.4.1 at the time the MFDA was recognized as a self-regulatory organization. Ultimately, MFDA Rule 2.4.1 was repealed and replaced by its current form which when taken in conjunction with administrative positions taken by various CSA jurisdictions effectively allows the practice of directed commissions by mutual fund dealing representatives in all CSA jurisdictions that recognize the MFDA, except Alberta (MFDA Rule 2.4.1 expressly does not apply in Alberta) and Newfoundland and Labrador.

Mutual fund dealers in British Columbia, Alberta, Manitoba, Québec, New Brunswick and Newfoundland and Labrador must also consider the overlay of the differential administrative positions taken by the securities regulators in those provinces. Each of these provincial commissions, other than the ASC and the securities regulators in Québec and NL (whose positions are discussed in the following paragraphs) have enacted a rule that permits directed commissions.

(a) In February 2002, the British Columbia Securities Commission (**BCSC**) passed BC Instrument 32-503 *Registration Exemption for Salespersons' Corporations.* The Instrument exempts an unregistered corporation from registration as a dealer "in connection with receiving commissions and fees from a dealer". The Rule is limited to MFDA members.

(b) In October 2007, the Manitoba Securities Commission (MSC) passed an order that is essentially the same as the BCSC instrument, although it is not restricted to MFDA members. As with the BCSC instrument, the MSC exemption is granted to an unregistered corporation "for the sole purpose of permitting the corporation to receive commissions and fees from a dealer".

(c) In September 2009, the New Brunswick Securities Commission passed a blanket order, which is now embodied in Local Rule 31-502. This Rule is drafted slightly differently from the rules/orders in British Columbia and Manitoba. It permits directed commissions, but specifically does not permit the corporation to conduct registrable activities. The rule is not restricted to MFDA dealers.

The Authorité des marchés Financiers (**AMF**) presently does not permit registered mutual fund dealers to allow directed commissions in Québec, which is a continuation of the position articulated by the Bureau des services financiers in a Bulletin published in March 2002. However in the AMF's consultation paper *Consultation on the Harmonization of Mutual Fund Distribution Regulations* released for comment on October 1, 2010, the AMF indicated that it would change its rules to permit the practice of directed commissions by mutual fund dealers registered in Québec. The National Assembly of Québec later introduced Bill *58 An Act to again amend various legislative provisions concerning mainly the financial sector,* which had it been passed into law would have amended the *Securities Act* (Québec) to permit "incorporated salespersons" in Québec (an expanded concept from that of "directed commissions"). Bill 58 expired with the change of government in Québec.

In November 2012, the Newfoundland and Labrador (NL) regulator came out with a pronouncement against directed commissions in Bulletin No.20 *Representatives Directing Commissions to Personal Corporations and Use of Business Names that are Similar to Incorporated Entities*. The NL Bulletin explains the NL regulatory position that payment of a commission or other remuneration to an individual or a corporation that is not registered in NL is not permitted, but does not provide any additional explanation

Appendix C

Incorporated Salespersons

Subject to the discussion below, incorporated salespersons are not permitted for any dealers (investment or mutual fund) under the current securities regulatory regime in Canada.

The implementation of an incorporated salesperson regime requires legislative amendments to be made to securities legislation. Under securities legislation in most Canadian jurisdictions, in order to carry on registrable activity – and by that we mean being in the business of trading or advising[12] – a person must either be registered as a dealer (e.g., an investment dealer) or as an adviser (e.g., portfolio manager) or be registered as a representative of a registered firm. Generally, "representative" means an individual under securities legislation in Canada. And, under IIROC Dealer Member Rules, the relationship between an IIROC Dealer and its dealing representative can be either an employer-employee relationship or a principal-agent relationship[13]. The result of these provisions is that an incorporated entity is not permitted to be registered as a representative without legislation amendments.

Some CSA jurisdictions have been working on legislative amendments to their respective securities acts to establish a statutory framework that allows the concept of an incorporated salesperson (referred to in those jurisdictions as "professional corporations") while ensuring that investor protection issues are addressed, but to date no such amendments have been brought into force[14].

We note, as well, that the revised consultation draft of the *Capital Markets Act* that was published in August 2015 (as contemplated by the Memorandum of Agreement regarding the Cooperative Capital Market Regulatory System) provides for the concept of a "professional company" which is a company that is registered and acts as a dealer or adviser on behalf of another dealer or adviser through one or more registered individuals.

[12] For purposes of this White Paper we will not discuss acting as an investment fund manager which is also a registrable activity under securities legislation.

[13] See IIROC Dealer Member Rule 39.3.

[14] For example, each of Alberta and Saskatchewan has passed, but not yet proclaimed in force, legislation permitting "professional corporations" to be registered under their respective securities laws to act, subject to conditions, as a dealer or adviser through registered individuals.