

# IIROC NOTICE

## **Rules Notice Guidance Note**

Dealer Member Rules

*Please distribute internally to:*  
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## **Managing Conflicts in the Best Interest of the Client**

The purpose of this notice is to affirm IIROC's intention to strengthen compliance by our Dealer Members with the best interest requirements of our Conflicts of Interest rule, with particular focus on the management of compensation-related conflicts.

### **Overview**

On March 31, 2016, the Canadian Securities Administrators (CSA) announced their intention to publish CSA Consultation Paper 33-404 – *Proposals to Enhance the Obligations of Advisers, Dealers and Representatives Toward Their Clients*. This paper will follow the CSA's 2013 consultation on the appropriateness of introducing a statutory best interest standard when advice is provided to retail clients.

We agree with the CSA that regulatory action is required to better align the interests of registrants to the interests of their clients, to improve outcomes for clients. And we are committed to working with the CSA through this consultation process to ensure a consistent standard of care for all regulatory platforms.

At IIROC, we are focusing on the management of compensation-related conflicts of interest, which we believe is a key part of any discussion regarding the alignment of registrants' interests to those of their clients.

The need for this alignment is already a guiding principle inherent within IIROC's current regulatory regime. We believe that, taken together, our Dealer Member Rules and guidance put the best interest of the client before the interests of IIROC-regulated dealers and their representatives. We acknowledge that further clarification of our rules and guidance may be necessary to make this point absolutely clear.

This principle is also specifically reflected in our rule that requires a firm's *representatives* to address material conflicts of interest – whether existing or potential – in a manner that is *consistent with* the best interest of the client. Recognizing that *firms* must balance the interests of multiple clients simultaneously, our rule requires them to address such conflicts in a manner that *considers* the best interest of the client.

As a public interest regulator, IIROC is committed to improving oversight of our Dealer Members and their representatives in order to protect investors and support healthy capital markets. We expect that each firm will have appropriate policies and procedures in place to ensure compliance with our “best interest” requirements. Dealers and Approved Persons should not act in a way that benefits them to the detriment of their clients.

However, our recent examination of conflicts of interest management practices of IIROC-regulated firms indicates firms can and should improve the way they supervise and address existing and potential conflicts of interest.

Therefore, to strengthen compliance by our Dealer Members with our requirements concerning conflicts of interest, and in particular compensation-related conflicts, we are enhancing our compliance examination program to focus on these conflicts and will consider whether further rule and/or guidance changes are required.

### **Our principle-based conflicts of interest rule**

Dealer Member Rule 42 is a principle-based rule that is supplemented by guidance<sup>1</sup>. Under the rule and guidance, Dealer Members must address conflicts of interest that do, or could, arise with different business models. For example, the rule requires that all existing or potential material conflicts of interest between a Dealer Member and a client must be addressed

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<sup>1</sup> IIROC Guidance Notice 12-0108, “*Client Relationship Model – Guidance*”.

*“in a fair, equitable and transparent manner and considering the best interests of the client or clients”,*

and that those between an Approved Person and a client must be addressed

*“in a fair, equitable and transparent manner, and consistent with the best interests of the client or clients”.*

Further, any existing or potential material conflict of interest that cannot be addressed in that manner must be avoided (emphasis added).

Our related guidance is designed to help Dealer Members achieve the regulatory outcomes we expect. The guidance deals with, among other things, methods of addressing conflicts of interest (through avoidance, disclosure or controlling the introduction and supervision of new products, for example). Our guidance also addresses the identification of conflicts of interest specifically relating to product due diligence<sup>2</sup>, and managing the potential conflicts of interest that may arise when a Dealer Member and an issuer are related<sup>3</sup>.

Our principle-based approach to managing conflicts of interest recognizes the diversity in business models among IIROC-regulated firms, and provides flexibility in implementing an effective regime to manage conflicts of interest that complies with the letter and spirit of our rules.

### **Areas for improvement**

In late 2014, we reviewed the conflict-of-interest-related issues that arose during our normal course examinations of Dealer Members during a 13-month period in 2013-14, to determine the extent to which they were complying with our conflicts of interest rule. Our review showed deficiencies in:

- (i) policies and procedures concerning conflicts of interest;
- (ii) documentation concerning the analysis of specific conflicts; and
- (iii) disclosure of conflicts to clients.

These findings suggested weaknesses in the oversight of the conflicts of interest management process within some IIROC-regulated firms.

In our view, inadequate oversight will inevitably result in conflicts not being identified, or in conflicts not being addressed in a manner that considers the best interests of the client. In particular, without an adequate oversight process, it is unlikely that firms will be able to identify and address conflicts relating to compensation practices and new products.

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<sup>2</sup> IIROC Guidance Notice 09-0087, “*Best Practices for Product Due Diligence*”.

<sup>3</sup> IIROC Guidance Notice 13-0039, “*Recommendations and Best Practices for Distribution of Non-Arm’s Length Investment Products*”.

As a follow-up, in June 2015 we conducted a targeted survey of a representative sample of IIROC-regulated firms<sup>4</sup> regarding the identification and management of conflicts of interest in three different areas:

- (i) the overall framework Dealer Members have in place to identify and address all applicable conflicts of interest;
- (ii) the effectiveness of controls used to identify and address conflicts relating to compensation practices, including incentives based on the targeted marketing of certain products or account types, and compensation thresholds based on sales volume; and
- (iii) the effectiveness of controls to identify and address conflicts relating to the marketing and distribution of new products.

We found that Dealer Members in the sample had improved their policies and procedures for dealing with basic conflicts in areas such as outside business activities, separation of corporate finance and research activities from retail sales activities, and the disclosure of affiliated entities and proprietary products. We also determined that, with a few notable exceptions, generally those surveyed had implemented robust governance and oversight processes, and had incorporated an effective analysis of potential conflicts as part of their new product review process.

However, when it came to compensation-related conflicts, most firms sampled lacked a meaningful process to identify, deal with, monitor and supervise compensation-related conflicts. For example, most firms did not have mechanisms in place to identify advisors who recommend products that yield higher fees and bonuses, when there are other suitable but less expensive alternatives available. They also did not have a process in place for implementing additional monitoring of advisors approaching compensation thresholds based on the amount of revenue generated.

Furthermore, we found that there was confusion among some firms regarding the best interest standard as set out in our conflicts of interest rule and guidance. Although most Dealer Members responded that they always put clients' best interests first, we found little supporting documentation as far as compensation-related conflicts were concerned.

### **Next steps**

We are taking specific actions to strengthen the culture of compliance among IIROC-regulated firms, and assist firms in more effectively managing compensation-related conflicts of interest, recognizing that materiality and reasonability need to be taken into consideration in this exercise. We will:

- (i) immediately enhance our compliance test procedures to more closely examine compensation grids, supervisory oversight of advisors recommending products with high commissions, and the monitoring of advisors approaching compensation thresholds;

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<sup>4</sup> We surveyed 19 Dealer Members representing a cross-section of business models and sizes.

- (ii) by June 2016, conduct a comprehensive survey to gather more detailed information on the oversight and monitoring of compensation-related conflicts by Dealer Members to ensure that we can accurately and completely assess the quality of the controls being used;
- (iii) conduct follow-up targeted examinations of Dealer Members where concerns arise from the results of the survey; and
- (iv) use our survey and examination results to inform the appropriate regulatory response. This may include rule amendments and/or additional guidance on conflicts of interest that clearly and in plain language outline IIROC's best interest requirements.

These measures will assist firms and their representatives to identify, manage and supervise compensation-related conflicts of interest in accordance with the outcomes that we expect as a public interest regulator.

As noted above, we will continue to work with our regulatory partners to better align the interests of registrants to the interests of their clients through a consistent standard of care for all regulatory platforms, and may introduce further rule amendments and/or guidance as a result.