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17-0093
April 27, 2017

Managing Conflicts in the Best Interest of the Client – Compensation-related Conflicts Review

The proper management of conflicts of interest – and compensation-related conflicts in particular – is a priority focus for IIROC because we believe it is at the core of the best interest debate. In April 2016, IIROC published Notice 16-0068 – *Managing Conflicts in the Best Interest of the Client,* in which we affirmed our intention to strengthen compliance by Dealers with the best interest requirements of Dealer Member Rule 42 (**Conflicts Rule**) and undertook to conduct a comprehensive review of compensation-related conflicts (**Compensation Review**).

In December 2016, we published Notice 16-0297, providing an update on the Compensation Review. As we committed in that Notice, this report provides the details of our findings and analysis, along with our next steps.

The primary objectives of the Compensation Review were to:

- gain a greater understanding of the range of compensation practices in place at a cross-section of IIROC Dealers

- assess compliance with IIROC's conflict-of-interest rules – primarily the Conflicts Rule.

We conducted the Compensation Review in the midst of significant regulatory change and stakeholder consultation pertaining to compensation and fees, including:

- performance and fee/charge reporting, as required under the final phase of the Client Relationship Model reform initiative, coming into effect
- publication of Canadian Securities Administrators' (**CSA**) consultation papers regarding a client best interest standard and other targeted reforms[1], and embedded commissions[2].

While mindful of these initiatives, and similar reviews conducted by other Canadian regulators, we designed the Compensation Review with a focus on issues that are particularly relevant to IIROC Dealers.

We looked at compensation-related conflicts of interest from a number of different perspectives but certain key themes came up repeatedly throughout the review. The three most significant areas of concern are:

- reliance on disclosure without first addressing the conflict in another way, and poor quality of disclosure
- lack of comprehensive review of compensation programs and their associated conflicts
- a shift to fee-based and managed accounts without appropriate supervision and monitoring of the unique risks associated with these account offerings.

While disclosure has generally been accepted by regulators as a way to address conflicts, our concern is that Dealers and representatives are increasingly relying *solely* on disclosure without ensuring that the conflict has first been addressed in a way that is consistent with / considers the best interests of the client(s), or avoiding the conflict altogether. Furthermore, our view of disclosure as a solution continues to evolve with new research and independent studies calling into question the efficacy of disclosure, and highlighting its possible unintended consequences. We are aligned with the CSA in this view, as stated in CSA Consultation Paper 33-404:

[1] CSA Consultation Paper 33-404, *Proposals to Enhance the Obligations of Advisors, Dealers and Representatives Toward Their Clients*, April 2016

[2] CSA Consultation Paper 81-408, *Consultation on the Option of Discontinuing Embedded Commissions*, January 2017

"The application in practice of the current conflicts of interest rules is, in many instances, less effective than intended. Not only is the concern that disclosure may be ineffective in mitigating conflicts of interest, disclosure may have a counter-intuitive effect of increasing reliance on advice where the client is told such advice is, or potentially is, conflicted."

We agree with the CSA that disclosure alone is a generally inadequate mitigation mechanism because of its limited impact on a client's decision-making process, and that regulatory action is required to better align the interests of registrants to the interests of their clients. We agree in principle with the CSA's proposed targeted reforms and related guidance on conflicts of interest and we are committed to working with them to ensure our requirements are materially harmonized and will be implemented on the same schedule. As we collaborate, we will ensure that any amendments to and/or revised guidance on the Conflicts Rule clarify that:

- disclosure alone is not sufficient to address conflicts, particularly compensation-related conflicts
- conflicts must be avoided or addressed in another way before disclosure is considered.

We will also ensure that additional guidance is provided on the approaches Dealers should use to address conflicts of interest, with particular focus on the findings from the Compensation Review.

In the meantime, the guidance set out in this notice supplements and clarifies IIROC Guidance Notice 12-0108 – *Client Relationship Model* – March 2012, and should be applied by all IIROC Dealers, effective immediately.

IIROC's Business Conduct Compliance (**BCC**) team is taking immediate steps to strengthen our oversight of compensation-related conflicts by significantly enhancing our exam processes.

We recently issued a request for information from Dealers offering fee-based accounts. We asked them to identify where they have not followed their policies and procedures related to controlling conflicts associated with "double-charging", or where the best interests of clients have not been considered. Depending on the responses, we will take appropriate regulatory action. Any failure by a Dealer to self-report any issues will result in a referral to IIROC enforcement if we identify significant deficiencies during our next BCC exam of the Dealer. All

IIROC-regulated Dealers are subject to regular comprehensive examinations, with more frequent exams if we believe closer scrutiny is required to protect investors.

These steps will help Dealers and their representatives to identify, address and supervise conflicts of interest generally, and compensation-related conflicts of interest specifically, in accordance with the outcomes we expect as a public-interest regulator.

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1. Background to the review process

1.1 IIROC's conflicts-of-interest regulatory regime

IIROC's rules and guidance, and securities legislation, include a number of elements that pertain to conflicts of interest, including:

Conflicts Rule

Dealer Member Rule 42 is IIROC's general conflicts-of-interest rule and outlines the regulatory requirements applying to Dealers regarding their management of conflicts of interest. The Conflicts Rule is a principles-based rule that we supplement with guidance. It does not identify specific conflicts that must be avoided[3] but rather requires each Dealer to develop and maintain policies and procedures for identifying, avoiding and addressing material conflicts of interest. It specifically requires:

- the Dealer's representatives to address all material conflicts – whether existing or potential – in a manner that is consistent with the best interests of the client
- recognizing that Dealers must balance the interests of multiple clients simultaneously, the Dealer to address all material conflicts – whether existing, or potential – in a manner that considers the best interest of the client(s)[4]
- that conflicts that cannot be addressed in this manner must be avoided.

Prescriptive rules

For some types of conflicts (e.g. personal financial dealings[5]), we have prescriptive rules in addition to the Conflicts Rule. We do not have additional rules specifically on compensation-related conflicts.

Rules and guidance of general application

In addition to the Conflicts Rule, there are rules and guidance of general application (**Standards of Conduct**) that Dealers need to consider when addressing conflicts of interest, including:

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[3] Unlike, for example, NI 81-105 *Mutual Fund Sales Practices* which prohibits certain compensation practices.
[4] IIROC Dealer Member Rule 42.2(2) & 42.3(2)
[5] IIROC Dealer Member Rule 43

- Rule 1402, under IIROC's Consolidated Enforcement, Examination and Approval Rules[6], which requires Dealers and their representatives to observe high standards of conduct and not to engage in conduct unbecoming
- Dealer Member Rule 38.1 that requires Dealers to establish and maintain a system to supervise their activities reasonably designed to achieve compliance with all applicable laws (including the requirement under National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations, section 11.1 that Dealers have controls and supervision in place to manage the risks associated with their business)
- requirements under Canadian securities legislation that Dealers deal fairly, honestly and in good faith with clients.

For each finding discussed in section 2, we include comments on the rules and guidance that Dealers need to consider.

1.2 Identifying compensation-related conflicts

Identifying and dealing with compensation-related conflicts can be challenging. There are often many different components to the overall fees paid by a client. These different components can include:

- the cost of advice
- the costs associated with individual products
- the operational costs incurred by Dealers in order to process trades and provide client reporting.

The cost of advice is also complicated by the fact that fees may be charged directly by the Dealer (e.g. through up-front commissions or periodic fees) or may be paid for indirectly by issuers (e.g. through commissions or embedded trailer fees). Identifying a conflict will generally require considering these different components in isolation, in addition to considering the total fees paid.

The performance and fee reporting that is now required under IIROC Dealer Member Rule 200 should help clients determine whether they are receiving value for their money. However, many clients lack the required level of financial literacy to assess the quality of advisory

[6] Rule 1402 replaced Dealer Member Rule 29.1.

services they are receiving. Therefore, the onus remains on Dealers to ensure that the client's best interests have been considered when addressing compensation-related conflicts.

1.3 Analysis of compensation-related conflicts

An analysis of compensation-related conflicts will typically begin with considering:

- the Dealer's business model
- the products and services offered
- the Dealer's target market
- the fee options available for clients.

Providing a range of incentives to representatives, and rewarding performance, is an essential aspect of maintaining efficient capital markets. Apart from certain practices specifically prohibited by regulation[7], Dealers are free to design incentive schemes customized to their particular business model, subject to the overarching standard of the Conflicts Rule and Standards of Conduct. The compensation programs that many Dealers use to motivate their representatives contain various elements. The most basic element is the compensation grid. In addition to the basic grid payout, many Dealers offer a range of incentives, both monetary and non-monetary, to their representatives.

The different elements of a complex compensation program can result in a misalignment between the interests of clients and representatives. Therefore, it is essential that Dealers design supervision and monitoring systems to address the risks that are most relevant to their business models and compensation programs.

We designed our Compensation Review to focus on the following three areas:

1. Business Model – product shelf and account types offered
2. Compensation Program – compensation grids and other incentives
3. Supervision and Compliance Monitoring Processes

Appendix A contains a detailed discussion of findings in each of these areas.

[7] For example, NI 81-105 outlines various prohibited practices regarding mutual funds.

1.4 Review process

In order to capture different approaches to managing compensation-related conflicts, we reviewed a broad cross-section of Dealers serving retail clients.[8] We asked each Dealer to:

- respond to a series of questions
- provide supporting documentation including their compensation grids and compensation program documents, outlining all incentives offered
- meet with us to delve deeper into any concerns or questions we had arising from the written responses and supporting documentation.

2. Key findings and guidance

In this section, we discuss the most significant findings resulting from the Compensation Review, and identify applicable rules and guidance.

Under the discussion of applicable rules and guidance for each finding, we remind Dealers that the Conflicts Rule and Standards of Conduct apply to varying degrees to each finding, and highlight certain specific requirements that need to be met and/or guidance that Dealers should consider.

2.1 Conflict disclosure

2.1.1 Disclosure as a solution

In the Compensation Review, it became apparent that some Dealers consider disclosure to be an adequate method of addressing conflicts in all cases. While disclosure has generally been accepted by regulators as a way to at least in part address conflicts, the Conflicts Rule does not provide that disclosure alone is sufficient, and our current guidance clearly indicates that:

> *" As part of the requirement to address these compensation-related conflicts of interest and consistent with the requirements set out in subsections 42.2(2) and 42.3(2) to address conflicts of interest:*

[8] We selected 20 Dealers including large integrated Dealers as well as small and medium-sized retail Dealers. Business models based on a principle-agent structure were represented. Some Dealers offer an extensive range of third party products, whereas others focus primarily on proprietary products.

- *The Dealer Member should ensure its product and service offerings, including the fees associated with such offerings, are consistent with the overall wealth building objectives of its clientele; and*

- *The Approved Person should, in addition to determining, where applicable, whether a certain product or service is suitable for the client, ensure that the transaction, account and service fees and costs to be charged are fair and are properly disclosed to the client."* [9]

Our concern is that Dealers and representatives are increasingly relying *solely* on disclosure without first ensuring that the conflict has been addressed in a way that is consistent with / considers the best interests of the client(s), or avoiding the conflict altogether. Furthermore, our view of disclosure as a solution continues to evolve with new research and independent studies calling into question the efficacy of disclosure, and highlighting its possible unintended consequences.

We are aligned with the CSA in our view that disclosure alone is a generally inadequate mitigation mechanism because of its limited impact on a client's decision-making process, and that regulatory action is required to better align the interests of registrants to the interests of their clients.

<u>Applicable rules and guidance</u>

The Conflicts Rule and Standards of Conduct are relevant to this finding. It is important to emphasize that, under the Conflicts Rule, conflicts that cannot be addressed in a fair, equitable and transparent manner, consistent with / considering the best interests of the client(s) must be avoided. If a Dealer determines that it is appropriate to address a particular material conflict rather than avoid it, the Dealer must disclose the conflict.

Dealers should conduct an independent review of each material conflict to ensure that the way they have chosen to address the conflict considers / is consistent with the best interests of the client(s) rather than simply assuming that disclosure achieves this result. In most cases, conflicts cannot be addressed through disclosure alone; Dealers should take specific measures such as firm-wide controls and/or documenting best-interest assessments made by the Dealer's representatives. These measures should be taken in advance of disclosing the conflict to the client(s).

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[9] IIROC Guidance Notice 12-0108, *Client Relationship Model – Guidance,* March 2012, page 11.

2.1.2 Inadequate disclosure

We have seen many cases where disclosure is so vague as to be meaningless and in these cases, we have required firms to improve their disclosures. An example of poor disclosure involving products containing embedded compensation in a fee-based account is the following:

> *"Dealer Member Inc. may receive a fee or other payment from another party, other than me, for certain transactions made for my account. These may include trailer and administration fees."*

This type of disclosure is inadequate for four reasons:

1. It uses the term "may" when in fact the term "will" is more accurate.
2. The disclosure does not tell the client the nature of the conflict.
3. It is not clear that the client will ultimately be the one paying the additional fees, indirectly through "another party".
4. It assumes that investors are all financially literate and understand industry terms like "trailer fees".

Another common practice we identified involves a representative recommending certain products for which he/she also receives compensation for services provided in another capacity. In these cases, the disclosure is often located in different sections of a document, or in multiple documents, making it very difficult for a client to understand the full extent of the conflict.

<u>Applicable rules and guidance</u>
In addition to the Conflicts Rule and Standards of Conduct, Dealers should also consider the discussion in IIROC Guidance Notice 12-0108 on minimum standards that should be followed to ensure adequate disclosure:

> *"The disclosure should be timely and meaningful to the client. Specifically disclosure should be made before the product or service that is related to the conflict is sold or provided to the client. Further the disclosure should be specific to provide the client with an understanding of the specific conflict. A generic form of disclosure simply stating that conflicts may arise will not satisfy the Dealer Member's obligation to respond to specific conflict of interest situations that may arise."* [10]

[10] IIROC Guidance Notice 12-0108, *Client Relationship Model – Guidance,* March 2012, page11.

When disclosing a conflict, it is critical that the disclosure be prominent, complete and in plain language, and the nature of the conflict is evident to the client.

In addition to meeting the minimum standards of written disclosure outlined above, the representative should explain the nature of the conflict to the client and/or confirm that the client has actually read the disclosure.

2.2 Review and monitoring of compensation programs

2.2.1 Lack of review by Dealers

Although there are certain similarities, especially among Dealers of equivalent size and with comparable business models, no two compensation programs are identical. In addition to offering different incentives, Dealers use a variety of methods for calculating compensation. The CSA pointed out in CSA Staff Notice 33-318 that many of the different formulas used in compensation grids contain features that could result in a misalignment between the interests of representatives and those of their clients.[11]

Most Dealers can point to a high-level analysis of certain conflicts, most notably those involving related-party products, but few can provide evidence of conducting a detailed review of their overall compensation program, including all aspects of the compensation grid together with other incentives. Furthermore, few Dealers have implemented special monitoring processes to address the conflict risks identified through internal review.

Applicable rules and guidance

The Conflicts Rule and Standards of Conduct are relevant to this finding. We note that the Conflicts Rule requires that:

> *"Each Dealer Member and, where applicable, approved Person, shall take reasonable steps to identify existing and potential material conflicts of interest between the interests of the Dealer Member or Approved Person and interests of the client."*[12]

Dealers should also consider the discussion in IIROC Guidance Notice 12-0108 highlighting the importance of identifying compensation-related conflicts in particular:

[11] CSA Staff Notice 33-318, *Review of Practices Firms Use to Compensate and Provide Incentives to their Representatives,* December 2016.

[12] IIROC Dealer Member Rule 42

"Many conflict of interest situations are compensation related, where the Approved Person's/Dealer Member's interest in being compensated for a transaction is inherently in conflict with a client's interest in growing their wealth.........On the topic of compensation practices Companion Policy 31-103CP states that Registered Firms should consider whether any particular benefits, compensation or remuneration practices are inconsistent with their obligations to clients".[13]

(i) Scope of a Dealer's Review

Given that each compensation program contains unique risks, in order to ensure compliance with the Conflicts Rule it is essential that Dealers thoroughly review all aspects of their compensation program.

There is no IIROC-prescribed format for the review of compensation-related conflicts. However, a Dealer's internal review should identify all significant conflict risks in the Dealer's compensation program, and implement compliance monitoring processes to address the risks. For example, a Dealer that determines the compensation grid level for each representative based on a static look-back period could implement additional monitoring of representatives that significantly increase their sales level as the cut-off date approaches for calculating qualifying revenue.

We suggest that a complete review by the Dealer should include the three key areas covered in the Compensation Review: business models, compensation programs, and monitoring/supervision. In particular, the review should cover:

- business model – open architecture vs. proprietary products, principal-agent vs. employer-employee
- product review & approval processes
- recommended product lists
- compensation grids – formulas & time periods for calculation
- compensation program – overall impact of all incentives considered together
- compensation of supervisors
- sales targets & quotas.

[13] IIROC Guidance Notice 12-0108, *Client Relationship Model – Guidance*, page 11

(ii) The Role of Compliance

The expertise required to perform a complete analysis of the risks associated with compensation conflicts is often distributed among various units of a Dealer. This was apparent in our follow-up meetings where representatives from different units were required in order to answer all of our questions.

The relevant units of each Dealer should maintain policies and procedures that identify and address compensation-related conflicts. The role of Compliance staff is to ensure that any such policies and procedures are compliant with IIROC rules and applicable laws, and then to test their effectiveness and the firm's adherence to them[14].

2.2.2 Conflicted supervision

In most Dealers we reviewed, we saw supervisors compensated partly (to varying degrees) on revenue generated by registrants subject to the supervisor's oversight.

<u>Applicable rules and guidance</u>

The Conflicts Rule and the Standards of Conduct, particularly Dealer Member Rule 38 and 2500, are relevant to this finding. IIROC Dealer Member Rule 2500 III.A.3 requires that:

> *"A Dealer Member should ensure independent supervision of all retail accounts."*

While this rule is more frequently cited to ensure a producing supervisor does not have supervisory oversight over his or her own accounts, the spirit of the rule speaks to the need for genuinely independent supervision.

It is understandable that the compensation of a supervisor who is also a branch manager is based partly on the overall profitability of his or her branch. However, the Dealer should consider other factors in determining supervisor compensation that would offset any undue bias towards branch profitability at the expense of client best interest.

2.3 Fee-based and managed accounts

2.3.1 Compensation bias in favour of fee-based accounts

As part of the Compensation Review, we analyzed the breakdown of account types (e.g. commission-based, fee-based and managed) at each Dealer and the controls in place to

[14] See IIROC Dealer Member Rule 38.7 and IIROC Notice 12-0379 on *The Role of Compliance and Supervision*

ensure that clients are put into the most appropriate type of account. We also looked closely at additional fees and commissions associated with fee-based accounts.

The Compensation Review clearly indicated a bias on the part of most Dealers towards fee-based accounts over commission-based accounts: Most Dealers provide the highest possible grid payout to representatives for fee-based revenue. We also noted that, in addition to this maximum grid payout, a significant number of Dealers provide additional incentives to representatives in the form of performance bonuses linked to fee-based assets. Our concern is that clients may be moved into fee-based accounts, whether or not such accounts are consistent with the client's best interest.

When we asked Dealers to justify this preferential payout for fee-based revenue, most said they believe fee-based accounts align registrant interests with client interests better than commission-based accounts. While this may be true in some cases, there are other cases such as "buy and hold" where the client will be paying ongoing fees without receiving a commensurate level of ongoing service. Certain Dealers also stated that, given the attention placed on embedded compensation by the CSA, they are focusing on fee-based accounts as an alternative.

Most Dealers stated that they have processes to consider the *initial* appropriateness of a fee-based account for a client, but a small number do not. Most also stated that they have processes for the review of the *ongoing* appropriateness of fee-based accounts, but many could not provide any evidence of monitoring.

Applicable rules and guidance

While IIROC does not have specific rules on compensation for fee-based accounts, the Conflicts Rule and the Standards of Conduct are relevant to this finding. Whether a commission- or fee-based account is appropriate for a client will depend on the circumstances of the client. If a Dealer provides any form of monetary or non-monetary incentive in favour of fee-based accounts, it is essential that the Dealer have robust supervisory and monitoring processes in place to ensure that clients are placed appropriately in such accounts.

Most Dealers stated that their compensation grid is product-neutral, which we generally consider to be a best practice. In order to be truly neutral, however, a grid should not bias a representative in any respect. Compensation programs should be designed in such a way that there is no financial motivation to bias a representative towards either specific products or specific account types.

In addition to the initial suitability analysis, it is important that Dealers have processes in place for the ongoing monitoring of activity in a client's account, in order to assess the ongoing appropriateness of the account type.

2.3.2 Additional costs in fee-based accounts

We identified several instances where clients in fee-based accounts pay additional fees, or the advisor receives additional compensation, on top of the standard account fee.[15] These include, for example:

- hybrid accounts where the client pays an overall account fee, as well as a ticket fee or commission on all trades
- fee-based accounts that contain assets with embedded advisor compensation.

In instances where Dealers rely on processes to back out assets with embedded compensation, findings from numerous IIROC BCC exams provide evidence that these processes are generally manual and therefore error-prone. We have identified several cases where Dealers have not followed their documented policies and procedures.

In addition, in instances where Dealers rely on disclosure, we generally found the disclosure to be inadequate, as discussed in section 2.1.2.

Applicable rules and guidance

While IIROC does not have specific rules on "double-charging" in fee-based accounts, the Conflicts Rule and the Standards of Conduct are relevant to this finding.

In some cases, a hybrid account may in fact be the most cost-effective for a client, as long as the Dealer has taken the best interests of the client into consideration in structuring the aggregate fee (for example, by reducing the additional fees and/or the account fee) and it is clearly disclosed to, and acknowledged by, the client.

However, we believe the practice of "double-charging" raises significant conflicts of interest that in most cases are addressed best through controls or avoidance. For example, Dealers should have a controlled process to back out products with embedded compensation before calculating account fees.

[15] Most fee-based accounts charge a fee based on the value of assets in the account. In a smaller number of cases, especially where the assets are below a certain threshold, a flat fee is charged.

2.3.3 Compensation for affiliated managed-account programs

Given the fiduciary level of responsibility that applies to Portfolio Manager (PM) activities, there should be fewer compensation-related conflicts with managed accounts, as compared to non-managed, fee-based accounts. As expected, our review identified far fewer concerns with managed accounts, but we did identify one significant concern.

Two Dealers we reviewed provide a higher payout for in-house managed-account programs, than for comparable third-party managed-account programs. The rationale given by the Dealers in both cases was that the in-house programs had lower costs than the third-party programs. However, the client did not receive the benefit of the cost savings.

Contrary to the Conflicts Rule, by providing a biased financial incentive to favour related-party products over comparable third-party products, the Dealer is magnifying, rather than addressing, a conflict of interest.

Applicable rules and guidance

The Conflicts Rule and the Standards of Conduct are relevant to this finding. We note that In the case of mutual funds, National Instrument 81-105 *Mutual Fund Sales Practices* (**NI 81-105**) specifically prohibits Dealers from providing incentives to their representatives to recommend one family of funds over another. Although NI 81-105 does not apply to managed-account programs, the underlying concern is the same.

Similar to our guidance to eliminate any bias favouring fee-based accounts, Dealers should also eliminate any incentive favouring a particular product for any reason other than an incentive that has taken into consideration the best interests of the client as required under the Conflicts Rule.

3. Enhancing IIROC's business conduct compliance testing

All IIROC-regulated Dealers are subject to regular comprehensive examinations, with more frequent exams taking place if we believe closer scrutiny is required to protect investors. As part of the planning process for every exam, IIROC sends Dealers a request for information. We will now request the Dealer's compensation grid(s) as a standard item for every exam. In order to better review Dealers' treatment of compensation-related conflicts, IIROC's BCC team is putting in place the following enhancements to its procedures.

3.1 Compensation grids

We will assess a Dealer's grid to determine whether it is product-neutral and unbiased with respect to account type. If we have concerns, we will perform further investigations.

3.2 Compensation programs

BCC will ask Dealers about their policies and procedures concerning compensation programs. In particular, we will inquire about the identification of compensation risks and ongoing monitoring.

3.3 "Double-charging" in fee-based accounts

We recently issued a request for information from Dealers offering fee-based accounts, asking them to identify where their policies and procedures related to controlling conflicts associated with "double-charging" have not been followed, or where the best interests of clients have not been considered. Depending on the responses, we will take appropriate regulatory action. Any failure by a Dealer to self-report any issues will result in an automatic referral to IIROC enforcement if we identify significant deficiencies during our next BCC exam of the Dealer.

3.4 Disclosure

Going forward, BCC examiners will confirm that, prior to disclosing a conflict, Dealers have adequately addressed it. We will also take a far more critical look at the appropriateness and quality of conflict disclosure. If the disclosure does not clearly identify the conflict in plain, meaningful language, or if the disclosure is scattered in various places, BCC will consider the disclosure inadequate.

3.5 National Instrument 81-105

We have enhanced our procedures to include targeted, substantive testing of each of the following areas of NI 81-105:

- payments & benefits from Issuers
- preferential compensation for select mutual funds
- rebates
- cooperative marketing programs
- disclosure & client acknowledgement of equity interests.

3.6 Sales targets

The Compensation Review focused on incentives that function as rewards, both monetary and non-monetary. It is also possible that inappropriate sales activity will result from a Dealer setting overly aggressive sales targets that representatives must meet. BCC will ask Dealers to explain the rationale behind sales targets and controls they have implemented to guard against inappropriate sales activity.

3.7 Risk Trend Report

Effective risk management and intervening proactively to address activity that is harmful to investors is a priority for IIROC. As announced in our 2016/2017 Annual Compliance Priorities report[16] we are performing a comprehensive review of our risk models, which inform the frequency and content of compliance examinations. Among other changes, the BCC risk model will include a new risk factor that considers compensation arrangements.

4. Next steps

In addition to enhancing our BCC procedures as discussed in Section 3, we will work with the CSA to ensure our requirements are materially harmonized and will be implemented on the same schedule. As we collaborate, we will ensure that any amendments to and/or revised guidance on the Conflicts Rule clarify that:

- disclosure alone is not sufficient to address conflicts, particularly compensation-related conflicts
- conflicts must be avoided or addressed in another way before disclosure is considered.

We will also ensure that additional guidance is provided on the approaches Dealers should use to address conflicts of interest, with particular focus on the findings from the Compensation Review.

In the meantime, the guidance set out in this notice supplements and clarifies IIROC Guidance Notice 12-0108 – *Client Relationship Model* – March 2012, and should be applied by all IIROC Dealers, effective immediately.

[16] IIROC Guidance Notice 17-0010, *IIROC Compliance Priorities*, January 2017, page 2.

Appendix A – Detailed Discussion of Findings

Compensation Review Section 1 – Business Model

1. Business model

The Dealers selected for the review represented a variety of different business models including:

- Proprietary products - two Dealers in our review focus exclusively on proprietary products
- Open architecture - a majority of Dealers classified themselves as "open architecture" in that they allow their representatives to select from a limited to wide range of products.

Proprietary products

IIROC rules permit proprietary-product-based business models. We do not think that proprietary-product-only Dealers are inherently inappropriate on the IIROC platform. However, there are additional conflicts of interest associated with a product shelf comprised entirely of proprietary products that need to be addressed, including the possibility that the client suitability analysis will be based on what products are available, versus what is actually in the client's best interest.

Where a Dealer's product shelf is limited to proprietary products, the limitations must be disclosed in clear and plain language at the outset of the client relationship. In the case of the two Dealers in the review that focused on proprietary products, both firms' account-opening documents and Relationship Disclosure documents contained disclosure regarding the limited nature of their product shelf.

Open architecture – approval process and product due diligence

In theory, representatives at open-architecture Dealers should be able to offer their clients unbiased advice based on an assessment of the universe of investment products available. In reality, there are practical limitations regarding the ability of any one Dealer, let alone any individual representative, to be knowledgeable of all available product options. To varying degrees each Dealer, and each individual representative, will require some kind of filtering process to reduce all of the possible product alternatives down to a manageable subset that can be analyzed in depth. This filtering process typically begins with a standardized product-approval process.

Because the product-approval process is of fundamental importance in identifying potential compensation and fee issues, we made this a primary area of focus in the follow-up meetings we had with each Dealer. Although most Dealers we reviewed had a new-product-review committee, the criteria for individual products being subject to review differed from Dealer to Dealer. For example, we found cases where:

- only products considered high risk, or novel, were subject to review
- products originating from the same issuer received blanket approval
- products distributed by prospectus were not reviewed.

Guidance Notice 09-0087 discusses product due diligence:

> *"The extent of product due diligence required will vary with the regulatory obligations of the dealer to its clients but no dealer member that trades with or for its clients is automatically exempt from needing to conduct product due diligence."*[17]
>
> *"What investment needs does the product fulfill? How does the product add to or improve the firm's current offerings? Can less costly, complex, or risky products achieve the objectives?"*[18]

Furthermore, the Companion Policy to National Instrument 31-103 suggests a Dealer's product-approval process include a thorough review of all fees and commissions associated with a particular product.[19]

2. Recommended product lists

Approximately 25% of the Dealers reviewed provide their representatives with a list of recommended products that is generally compiled by a centralized research unit.

Once the Dealer has approved certain products for its product shelf, individual representatives are responsible for being knowledgeable about the characteristics of any product they recommend. This "Know Your Product" (KYP) process involves the representative reviewing the Dealer's product shelf, including product fees and costs, to determine products that may

[17] IIROC Guidance Notice 09-0087, *Best Practices for Product Due Diligence*, March 2009, page 2.
[18] Ibid, page 5.
[19] Companion Policy 31-103CP s.13.4 Compensation Practices - "*Registered firms should consider whether any particular benefits, compensation or remuneration practices are inconsistent with their obligations to the client, especially if the firm relies heavily on commission-based remuneration. For example if there is a complex product that carries a high commission, the firm may decide that it is not appropriate to offer that product.*"

be suitable for one or more of their clients.[20] Many Dealers play a key role in assisting their representatives in this respect.

We were concerned that a recommended product list could be used by a Dealer that purports to be open-architecture to favour certain products for self-serving reasons. Therefore, in the follow-up meetings the use of recommended product lists was a key area of focus. We analyzed each list to ensure that proprietary products were not being disproportionately favoured. We also interviewed the individuals responsible for creating the lists. Finally, we reviewed the Dealer's compensation grid to determine if there was any form of preferential payout for products on the recommended product list.

We did not identify any cases in our review where recommended product lists were used inappropriately to influence representative behavior.

3. Shelf fees

No Dealers in our review accept shelf fees from third-party product providers. In the case of mutual funds, the acceptance of shelf fees is a violation of National Instrument 81-105. While not strictly prohibited for other products, the acceptance of shelf fees would introduce serious conflicts of interest.

4. Performance fees

Three Dealers acknowledged accepting performance fees from the issuers of certain products. In particular, some pooled products and funds charge a performance-based fee and pay a portion of those fees to both the Dealer and the representative.

Any form of indirect incentive may inappropriately influence a representative and therefore could potentially be a violation of the Conflicts Rule. Such fees must be disclosed and consideration given to the clients' best interests.

5. Referral arrangements

The most common type of referral arrangement that we encountered in the Compensation Review pertained to sub-advisory agreements for third-party managed accounts. This type of arrangement can be a valid means of providing clients with managed-account services that the Dealer itself does not operationally support.

As discussed in National Instrument 31-103, Dealers have considerable freedom in the way they structure referral arrangements. Therefore, whether any particular referral arrangement is

[20] IIROC Notice 15-0210, *Mystery Shopping for Investment Advice*, September 2015, page 27.

in the best interests of clients will depend on the details of the referral arrangement; how much are clients ultimately paying because of the referral arrangement and are clients receiving value for their money?

6. Fee-based account focus

The results of the Compensation Review clearly indicated a bias on the part of most Dealers towards fee-based versus commission-based accounts as evidenced by:

- the growth in fee-based accounts at many Dealers
- the preferential compensation provided for fee-based revenue.

In order to delve deeper into this fee-based-account bias we asked Dealers to justify the reason for the higher payout for fee-based accounts. Most Dealers said they believe fee-based accounts align registrant interests with client interests better than commission-based accounts. While this may be true in some cases, there are other cases such as "buy and hold" where the client will be paying ongoing fees without receiving a commensurate level of ongoing service. Furthermore, certain Dealers also stated that given the level of regulatory scrutiny by the CSA on embedded compensation, they are focusing on fee-based accounts as an alternative.

Most Dealers stated that they have processes to consider the *initial* appropriateness of a fee-based account for a client, but a small number do not. Most also stated that they have processes for the review of the *ongoing* appropriateness of fee-based accounts, but many could not provide any evidence of monitoring.

7. Fee-based accounts – additional fees

We identified numerous practices where clients in fee-based accounts pay additional fees, in a variety of ways, on top of the standard agreed-upon account fee.[21] These include:

1. The charging of a ticket fee for each trade within a fee-based account. In the cases that we reviewed, the Dealer disclosed these ticket fees and the client acknowledged the additional fees.
2. Hybrid accounts where the client pays both a reduced commission on all trades and a reduced overall account fee. In the cases we reviewed, the overall fees being charged appeared to be reasonable and all applicable fees were clearly disclosed.

[21] Most fee-based accounts charge a fee based on the value of assets in the account. In a smaller number of cases, especially where the assets are below a certain threshold, a flat fee is charged.

3. Fee-based accounts that contain assets with embedded compensation. Most Dealers stated that they have procedures to identify such assets and to exclude them from the account fee calculation. Findings from numerous business conduct exams provide evidence that these processes are generally manual, and as a result, are error prone.

8. Fee-based accounts – disclosure

In certain cases, Dealers allow assets with embedded compensation to be included in fee-based accounts, subject to disclosure. We find disclosure is frequently used to deal with this and other conflicts.

Where the conflict has been addressed, and disclosure is provided, the disclosure must be in plain language and the nature of the conflict clearly explained to the client.[22] We identified numerous cases where the disclosure was vague, and scattered in different locations in a document or multiple documents.

Compensation Review Section 2 – Compensation Programs

1. Compensation grids – general payout formula

Most of the compensation grids we reviewed calculate the payout rates for individual representatives based on the amount of revenue generated by the individual over some defined period. However, there are significant differences in how revenue is calculated, and in the timeframe for the calculation. For example, some Dealers use a static look-back period to calculate total revenue generated, whereas other Dealers use a rolling look-back period. In a small number of cases, increases in the payout grid level are retroactive. Many of the grids we looked at also base the payout on individual transaction size.

As pointed out in CSA Staff Notice 33-318, many of the different formulas used in compensation grids contain features that could result in a misalignment between the interests of representatives and those of their clients.[23]

2. Compensation grids – product considerations

Virtually all of the Dealers in the review stated that their compensation grid is product neutral. However, based on answers to specific follow-up questions, we determined that a small

[22] IIROC Guidance Notice 12-0108, *Client Relationship Model – Guidance,* March 2012, page11.
[23] CSA Staff Notice 33-318, *Review of Practices Firms Use to Compensate and Provide Incentives to their Representatives,* December 2016.

number of Dealers do in fact provide additional compensation for certain proprietary products. In particular, two Dealers provide a higher payout for in-house managed-account programs than for comparable third-party managed programs. The rationale given by the Dealers in both of these cases was that the in-house programs have lower costs than third-party managed programs. The cost savings, however, were not passed on to the client and therefore the rationale given for the higher payout does not appear to be mitigated in any way that would be of benefit to the client. It is important to point out that the Compensation Review did not identify any cases where there was a preferential grid payout for proprietary mutual funds, which would have been a violation of National instrument 81-105.

3. Compensation programs – titles

In addition to the basic compensation grid payout, most Dealers provide additional compensation to their representatives through a variety of incentives, both monetary and non-monetary.

We identified three different types of incentives that concern us:

1. business titles
2. equity ownership programs
3. bonuses tied to fee-based assets.

In approximately one quarter of the compensation programs reviewed, representatives who achieved certain sales targets were rewarded with a prestigious business title. Generally, the title granted was that of Vice-President. The issue of misleading titles is a separate and distinct concern apart from compensation-related conflicts, but is relevant when they represent an incentive. IIROC Guidance Notice 14-0073 deals with the issue of misleading titles in general.[24] Titles can be misleading if they imply that the individual holds more decision-making authority in the Dealer than he or she actually does, or if the title suggests some special expertise or experience that the individual does not possess.

4. Compensation programs – equity participation

Many of the compensation programs that we reviewed include various types of equity participation plans. The nature of these programs differs significantly from firm to firm. Encouraging employee ownership is generally a valid form of incentive. However, in certain cases, we saw programs that award points based on selling only certain products. Although

[24] IIROC Guidance Notice 14-0073, *Use of Business Titles and Financial Designations*, March 2014.

we did not see any instances where employees would qualify for ownership points based solely on the sale of proprietary products, we did see cases where the group of qualifying products was heavily weighted in favour of proprietary products.

5. Compensation programs – performance bonuses

As previously noted, many Dealers grant the highest payout on their grid for fee-based revenue. During our review we also noted that a significant number of Dealers provide additional incentives to representatives in the form of performance bonuses that are based on fee-based assets. These additional incentives can take different forms. For example, representatives who bring in a certain amount of new fee-based assets will be eligible to move up to a higher grid-payout level. In another case, a quarterly performance bonus is paid based primarily on fee-based revenue. In a third case, annual performance bonuses are rewarded based on a variety of factors, one of which is fee-based assets exceeding a certain threshold of total assets under management.

Compensation Review Section 3 – Supervision & Monitoring

1. Monitoring – compensation

The extent to which Dealers have conducted a detailed review of all aspects of their compensation program was a primary focus at the follow-up meetings held with each Dealer. We found that only a small number of Dealers could point to specific monitoring processes designed to address high-risk scenarios associated with their compensation program. Most have not implemented anything beyond standard tests pertaining to suitability and churning.

Virtually all of the Dealers in our review have implemented some form of automated compliance monitoring system. Most of the systems, both third-party and proprietary, that we looked at identify basic suitability issues. However, a few cases we looked at appeared to have functionality designed to detect excessive fees.

2. Fee-based accounts – new issues

We identified cases where certain representatives recommended the frequent purchase of new issues for fee-based client accounts; positions typically held for only a short period. This type of activity may be indicative of a representative making recommendations primarily based on personal benefit from the new-issue commission rather than client suitability. This activity is more problematic in the case of fee-based accounts because the client would typically be more sensitive to commissions paid for each transaction in a commission-based account. As part of the follow-up meetings, we asked each firm whether they had special monitoring in place for this scenario. Only a small number of Dealers had implemented specific tests to identify inappropriate activity regarding new issues in fee-based accounts.

3. Conflicted supervision

The final question in the Compensation Review dealt with the compensation of supervisors. In most cases, we determined that supervisor compensation is based partly on revenue generated by registrants subject to their supervisory review. Many Dealers stated that the risk of conflicted behavior on the part of their supervisors is mitigated by other factors. For example, in some cases, in addition to partly compensating supervisors based on branch profitability there is also a discretionary portion based in part on overall adherence to compliance standards. There was generally no evidence provided, however, of Dealers conducting any review to determine whether the mitigating factors are in fact effective.