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.

<u>Proprietary products</u>

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.

<u>Open architecture – approval process and product due diligence</u>

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

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[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

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[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.