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Policy options for leveling the advisor compensation playing field

<https://www.ciro.ca/news-room/publications/policy-options-leveling-advisor-compensation-playing-field>

Member Regulation Policy
Canadian Investment Regulatory Organization
Suite 2000
121 King Street West
Toronto, Ontario M5H 3T9
e-mail: memberpolicymailbox@ciro.ca

Market Regulation
Ontario Securities Commission
Suite 1903, Box 55
20 Queen Street West Toronto, Ontario M5H 3S8
e-mail: marketregulation@osc.gov.on.ca

Capital Markets Regulation
B.C. Securities Commission
P.O. Box 10142, Pacific Centre
701 West Georgia Street, Vancouver, British Columbia, V7Y 1L2
e-mail: CMRdistributionofSROdocuments@bcsc.bc.ca

Introduction

Although not an investor protection priority, Kenmar is providing an input to this consultation on directed commissions that will benefit CIRO registrants. CIRO is proposing measures that could reduce the taxes payable by its approximately 108,000 registered representatives across Canada.

Kenmar Associates is an Ontario-based privately-funded organization focused on investor hosted at www.canadianfundwatch.com. Kenmar also publishes ***the Fund OBSERVER*** on a monthly basis discussing consumer protection issues for retail investors. Kenmar are active participants in regulatory consultations affecting retail investors. An affiliate, Kenmar Portfolio Analytics, assists, on a no-charge basis, abused consumers and/or their counsel in filing investor complaints and restitution claims.

Historically, mutual fund dealers have been permitted to pay commissions received from registrable activity by Approved Persons who are in a principal/agent dealer relationship to a private unregistered corporation where permitted by the provincial regulator. However, investment dealers can only pay commissions directly to their Approved Persons. CIRO aims to "level the playing field". They have proposed three

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different policy options for consideration but have indicated a preference for the Incorporated Approved Person model.

Despite reference to directed *commissions* the proposal covers all manner of registrant compensation including salary, stock awards etc.

For Kenmar, the major concerns involve accountability, investor restitution and CIRO fine collection. As the contractual relationship is between a Registered Dealer and the client, it would appear retail investor protection is not an issue associated with directed commissions.

Furthermore, based on many years of MFDA experience with directed commissions, there were no direct investor protection issues reported.

According to the Position paper, the preliminary view of CIRO staff is that the incorporated Rep model is their preferred approach because under the proposed model, the SRO would have oversight of Repts' corporations and the policy could be implemented relatively easily by changing the SRO's rules. CIRO believe this approach would be less burdensome than the alternative of requiring Repts to use corporations that are registered by the provincial securities regulators

Commentary

Definitions per position paper:

"Registerable activities": A term used to refer to activities that require registration [securities regulation]. Changes to securities legislation will be required for these activities to be carried out within a personal corporation on the sponsoring Dealer Member's behalf. We added the brackets for clarity.

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

As our knowledge of this method of compensation is limited, we limit our commentary to questions/ food for thought.

All written, electronic and verbal communications with clients should be via Dealer channels.

It would have been useful to know the CRA opinions on the proposed alternatives. Per the position Paper, compliance with applicable tax laws would remain the responsibility of the Approved Person and their sponsoring Dealer Member.

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Would there be any restrictions on the nomenclature such corporations could use? Is there a chance for client confusion? It is our understanding that the name must not be misleading and that business conducted within the corporation on behalf of the sponsoring Dealer must be conducted in the name of the sponsoring Dealer. We assume existing rules on holding out would apply.

We have been informed that CSA/ CIRO registration check will cite the name of the individual and make reference to the corporation. Will FSRA FA Credential check cite the name of a FA titled individual and make reference to the corporation (if dual registered)?

The use of directed commissions may involve provincial Labour laws and associated employment standards Acts. A CIRO response to our enquiry made it clear that any registered person would be eligible for directed commission tax treatment. At the same time the consultation paper is clear: " *we expect that Approved Persons and their sponsoring Dealer Members will ensure compliance with applicable tax laws.*". Compliance with Federal and provincial Labour laws is a given.

Again, a CIRO response to an enquiry confirmed that the directed commission approach would apply to all manner of compensation including bonuses, sales commissions and stock option grants.

We have been informed that directed commissions will not impact fine collection or civil litigation against a registered individual.

The process should ensure that at all times liability rests with the registered person. Is there a need for registered persons utilizing personal corporations be required to carry E&O insurance as doctors and lawyer professionals do?

What controls would be necessary to continuously monitor the corporations, how much will it cost and who will pay? A usual, we expect the added costs of the scheme will ultimately be flowed down to retail investors.

Is a two-year transition period to allow mutual fund dealers and their Approved Persons to comply with any new requirements too long?

Response to Questions

Question #1 *This paper discusses compensation approaches that could be made available for use to all CIRO Approved Persons. Which of the following rulemaking options do you prefer that CIRO pursue and why: • pure adoption of an Incorporated Approved Person approach, • pure adoption of a registered corporation approach, or • interim allowed use of an enhanced directed commission approach while pursuing over the medium-term the adoption of either: of an Incorporated Approved Person approach, or a registered corporation approach.*

CIRO staff's preliminary position is to pursue an Incorporated Approved Person approach, as it provides the most flexibility, transparency, and oversight for

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Approved Persons and their corporations, while minimizing the regulatory burden. If directed commissions are to prevail in the industry, this appears to us to be the most pragmatic choice based on the information available.

Question #2 - *Are there other requirements not discussed in this paper that CIRO should include within any rule amendments it proposes relating to acceptable compensation approaches?*

Should CIRO permit unregistered individuals to own shares in these corporations if they are employees of the corporation? Share ownership could be a valuable tool in recruiting and retaining skilled employees.

What sanctions would apply if the registrant breaches the Agreement or a Dealer fails in its monitoring obligations?

What action would CIRO take if the corporation was found to run afoul of tax laws, money laundering legislation, financing terrorism laws, labour laws or other serious offense?

Question #3 *Are there other matters not discussed in this paper that CIRO should consider when assessing which policy option to pursue?*

Kenmar expect that appropriate safeguards will be put in place to ensure that client privacy information is not impaired as a result of the directed commission corporation model.

CIRO will rely on Dealers approval to automatically approve the incorporated Approved person application subject to periodic inspection by CIRO. What ongoing monitoring obligations will Dealers have after initial approval of the incorporated Approved person application?

While we certainly concur that lines of business unrelated to financial services should be constrained, the definition of what is permissible should recognize reality and financial services industry maturation. The rule should utilize language recognizing financial services such as financial planning, retirement planning and tax optimization beyond today's focus on trading and advising in securities. These adjacent services are sorely needed and wanted by Canadians.

Summary

It is our understanding that Dealers will be required to supervise an Incorporated Approved Person (IAP) and will remain liable to clients and third parties for the acts and omissions of the IAP.

Based on information provided, we see no material investor protection benefit of, or risk associated with, the CIRO preferred directed commission corporation approach as described.

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The workload on Dealers to assess the corporation could potentially increase costs which would ultimately be offloaded onto clients of the Firm.

Kenmar agree to public posting of this letter.

We sincerely hope this feedback proves useful to Policy and decision makers.

Ken Kivenko, President
Kenmar Associates