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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
Retail
Senior Management
Training

Contact:
Robert Keller, Policy Counsel
Member Regulation Policy
416-943-5891
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12-0253
August 14, 2012

Request for comments on draft guidance regarding compensation structures for retail investment accounts

The Investment Industry Regulatory Organization of Canada ("IIROC") has prepared a draft Guidance Note regarding compensation structures for retail investment accounts.

Dealer Members and other interested parties are requested to provide comments on the issues discussed in this draft Guidance Note, which is attached. We encourage, in particular, IIROC regulated persons who deal directly with retail clients, such as Registered Representatives, to review this draft guidance and provide feedback based on their own experiences with handling various account compensation structures, including commission- and fee-based accounts. Comments should be provided 90 days from the publication date of this request for comments.

Comments regarding the attached draft Guidance Note may be delivered in writing by mail or e-mail within 90 days of the date of this Notice to:

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12-[xxxx]
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Compensation structures for retail investment accounts

Over the past decade, the types of services made available to retail brokerage clients in Canada have evolved considerably, with an increasing array of service offerings and cost options for clients to choose from. To promote transparency and investor protection, the Investment Industry Regulatory Organization of Canada ("IIROC") believes it is important for IIROC Dealer Members and Approved Persons to be cognizant of how the specific compensation arrangements that they offer their clients can affect their obligations under IIROC Rules.

This Guidance Note identifies specific considerations that should be taken into account by Dealer Members and Approved Persons when they are designing, recommending or supervising the various compensation arrangements that may be available to retail clients.

International developments in advisor compensation

In recent years, securities regulators around the world have been increasingly focused on the issue of advisor compensation and, in particular, on the impact that different compensation arrangements can have on the quality of investment advice provided by advisors to retail brokerage clients. Among other issues, regulators have looked at how compensation arrangements can create or alleviate conflicts of interest between an advisor and their client.

In the United Kingdom, for instance, a rule adopted by the Financial Services Authority (the "FSA") in March

2010 (effective January 1, 2013) bans all commissions paid by financial product providers to investment advisors.[1] As part of its "Retail Distribution Review"—a comprehensive review and overhaul of its rules governing retail investment advisors—the FSA determined that third-party commissions introduced an unacceptable bias into the sales process. Going forward, all compensation for investment recommendations in the U.K. (including commissions payable on product sales) will be required to be paid by the retail client directly to the investment advisor, based on a price list or tariff that the advisor is required to provide to the client up front.[2]

A similar ban on third-party commissions has been proposed by the European Commission as part of its pending revision of the Markets in Financial Instruments Directive, published in October 2011 (commonly known as "MiFID 2") with respect to (1) portfolio managers and (2) advisors who wish to hold themselves out as "independent" under a newly proposed regulatory framework.[3] In Germany, meanwhile, regulators have stopped short of an outright ban, but are considering new rules that would require a "passing-on of commission" (essentially, a rebate of the third-party payment) by the investment advisor to the client.[4]

In March 2012, the Australian House of Representatives passed two separate bills, known jointly as the "Future of Financial Advice" reforms.[5] Among other significant changes included in the legislation is a "prospective ban on conflicted remuneration structures including commissions and volume based payments, in relation to the distribution of and advice about a range of retail investment products."[6]

The emergence of significant and wide-reaching advisor compensation-related reforms around the world underscores the need for Canadian regulators, industry and investors to be aware of these international developments and to monitor their impact, if and when implemented. Against this backdrop, IIROC staff

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[1] See FSA, *FSA factsheet for Financial Advisers – Improving your understanding of the Retail Distribution Review (RDR) – Adviser Charging* , online: <http://www.fsa.gov.uk/smallfirms/your_firm_type/financial/pdf/rdr_adviser.pdf> at 2.

[2] *Ibid.* at 1.

[3] See European Commission, *Proposal for a Directive of the European Parliament and of the Council on markets in financial instruments repealing Directive 2004/39/EC of the European Parliament and of the Council* (Oct. 20, 2011), online: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0656:FIN:EN:PDF> at 8, 78; see also Sophie Ahlswede, *MiFID 2: Investment advice in Europe to be redefined* (Nov. 4, 2011), online: <http://www.dbresearch.com/PROD/DBR_INTERNET_EN-PROD/PROD0000000000280327.pdf> at 2. The European Parliament, however, has recently introduced amendments to MiFID 2 that would eliminate the ban on third-party commissions, even for so-called "independent" advisors. See Nick Reeve, *FT Adviser*, "Mifid amendment calls for commission ban to be scrapped" (Mar. 29, 2012), online: http://www.ftadviser.com/2012/03/29/regulation/eu-legislation/mifid-amendment-calls-for-commission-ban-to-be-scrapped-WmaTS7n8IHtelsl3QTQzkO/article.html>.

[4] See Ahlswede, *supra* note 3, at 2 ("Two options are being considered...: either the product vendor provides information about net costs in addition to the 'intermediary costs' or advisors are obliged to pass on such commission to their clients. The latter option is likely to be the less draconian and at the same time an efficient method.").

[5] See Australian Securities and Investment Commission, *Future of Financial Advice*, online: <http://www.asic.gov.au/asic/ASIC.NSF/byHeadline/Future%20of%20financial%20advice>.

[6] *Ibid.*

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are issuing for comment this guidance note, which addresses the steps that Dealer Members and their investment advisers should be taking in connection with the various compensation arrangements that they may be offering to retail clients in order to ensure ongoing compliance with existing IIROC Rules.

Account type

In light of IIROC's current regulatory framework, an analysis of account types through the lens of compensation structure shows that retail securities accounts can be grouped into the following three basic categories:

1. Order-execution service accounts (also referred to as "discount online brokerage accounts");
2. Advisory accounts (also referred to as "non-discretionary accounts"); and
3. Managed accounts (also referred to as "non-advisory accounts").[7]

Order-execution service accounts

Order-execution service accounts represent approximately 23% of all assets held in Canadian retail brokerage accounts.[8] These accounts impose the lowest degree of responsibility on Dealers for the investment decisions made in a retail account. To qualify to offer order-execution service accounts to clients, the Dealer Member must obtain an exemption under IIROC Dealer Member Rule 1300.1(t) from the suitability requirements set forth in Rule 1300.1(p). See IIROC Dealer Member Rule 1300.1(r). The exemption is conditional upon the Dealer Member's ongoing compliance with the requirements set forth in IIROC Dealer Member Rule 3200.

Since order-execution service accounts are not subject to the suitability assessment obligation that applies to full-service accounts, many of the compensation-related regulatory issues discussed below in connection with other account types are not relevant to this category of account. Nevertheless, Dealer Members are reminded that, pursuant to IIROC Dealer Member Rule 2500, they are required to have in place policies and procedures enabling them to adequately monitor trading in all order-execution service accounts—which generally apply fixed commissions to specific trades—in order to detect and prevent fraudulent, manipulative, or other unlawful trading activity, just as is required for traditional full-service commission-based accounts.

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[7] See IIROC Dealer Member Rule 3500.2 (listing and defining three "account relationship types": "advisory account," "order-execution service account," and "managed account") (published in IIROC Notice 12-0107, Rules Notice – Notice of Approval/Implementation, *Client Relationship Model – Implementation* (Mar. 26, 2012), online: <http://docs.iiroc.ca/DisplayDocument.aspx?DocumentID=C168CD670F80468EB38BC6EF773ECC41&Language=en>, at 5 (Attachment A)). Note that Rule 3500, while already approved by the relevant securities regulatory authorities, will become effective on March 26, 2013 for new clients of Dealer Members and March 26, 2014 for existing clients.

[8] Based on figures for December 2011. See Investor Economics, *Retail Brokerage and Distribution Advisory Service*, Winter 2012.

Managed accounts

In a managed account, which falls on the other end of the spectrum from an order-execution service account, the Dealer Member and its employees or affiliates have ongoing discretion with regard to investment decisions. While managed accounts still represent only a relatively small fraction of the overall retail brokerage market in Canada (approximately 9.1% of all retail brokerage assets as of December 2011), their popularity has grown considerably over the past decade.[9]

Specific IIROC Rules govern how managed accounts must be administered, including the ways in which Dealer Members and other regulated persons may be compensated for services provided through these accounts. In particular, Dealer Members are reminded of the following obligations they have under existing IIROC Rules:

- in a managed account, charges must not be based on the volume or value of transactions initiated for the account or be contingent upon profits or performance, unless the client has agreed to such charges in writing (IIROC Dealer Member Rule 1300.16);
- a Dealer Member may not pay anyone managing a managed account on the basis of the value or volume of transactions in the account (IIROC Dealer Member Rule 1300.17); and
- except as specifically permitted in IIROC Rules and rulings, a Dealer Member may not charge a client a fee that is contingent upon the profit or performance of the client's account (IIROC Dealer Member Rule 1300.21).

In addition, Dealer Members are reminded of the specific supervisory obligations that apply to managed accounts, as set out in IIROC Dealer Member Rule 1300.15.

Advisory accounts

Advisory accounts can be further broken down into 2 sub-categories:

(1) Commission-based accounts: In these accounts, a client pays a flat transaction fee for every trade executed, but pays no commission when declining a trade recommendation made by their advisor or when the recommendation is that the client take no action. This commission structure has been the traditional compensation arrangement in the retail brokerage industry for many years, and it continues to dominate the industry to this day. For example, as of December 2011, approximately 57% of all retail brokerage assets in Canada were held in commission-based accounts.[10]

(2) Fee-based accounts: these accounts, which tie Dealer Member and advisor compensation to a flat or percentage-based fee, are an increasingly popular alternative. Between December 2001 and December 2011, for example, the percentage of assets held within fee-based accounts in Canada more than doubled, increasing from approximately 4.3% to just under 10.7% of total retail

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[9] *Ibid.*

[10] *Ibid.*

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brokerage assets.[11]

The remainder of this Guidance Note will focus on the regulatory issues that arise in connection with commission-based and fee-based advisory accounts.[12]

Client Relationship Model

Earlier this year, IIROC implemented new rules, known collectively as the Client Relationship Model ("CRM"), intended to enhance various aspects of the relationship between Dealer Members and their retail clients. These enhancements addressed the following four regulatory objectives:

1. Relationship disclosure;
2. Conflicts of interest management/disclosure;
3. Suitability assessment; and
4. Account performance reporting.[13]

At the heart of the relationship between an investment advisor and their client is the manner in which the investment advisor is compensated for the services they provide to their client. In an IIROC Guidance Note issued on the same day that implementation of CRM was announced, staff noted with regard to "existing requirements in the IIROC Dealer Member Rules," that:

> [T]he suitability analysis starts before the order is even received, recommended or executed. The Dealer Member and Registered Representatives, at the time of account opening, should ensure that the account type (margin, trust, option accounts, etc.) is appropriate for the

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[11] *Ibid.*

[12] One additional compensation arrangement that bears mentioning is the hourly rate (i.e., charging for the provision of investment advisory services on an hourly basis). In practice, however, such an arrangement appears to be rare amongst IIROC Dealer Members and Approved Persons, although it is common for other professionals, such as certified financial planners. See e.g. Financial Planning Standards Council, *10 Questions to Ask Your Planner*, online: <https://www.fpsc.ca/node/311#6> at para. 7 ("Although the amount you pay the planner depends on your particular needs, the financial planner should be able to provide you with an estimate of possible costs based on the work to be performed. Such costs would include the planner's hourly rates or flat fees, or the percentage he would receive as commission on products you may purchase as part of the financial planning recommendations."). Given our focus on IIROC Dealer Members and Approved Persons, this Notice does not provide specific substantive guidance on hourly compensation arrangements. To the extent that an IIROC Dealer Member or Approved Person were to implement a compensation structure based on an hourly rate, however, we believe that the general considerations regarding suitability and supervision set out below, see *infra*, would also be substantially relevant to accounts subject to an hourly rate.

[13] IIROC Notice 12-0107, *supra* note 7, at 1. Implementation of the Rules addressing the first three objectives began on March 26, 2012; implementation of the fourth objective (account performance reporting), however, has been deferred, as required by the Canadian Securities Administrators. See *ibid.*

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client given the client's particular circumstances.[14]

When assessing the overall suitability of an account type, one of the key factors that Dealer Members should consider is the account's compensation structure. In addition, it should be noted that under CRM, Dealer Members will be required to address relationship disclosure issues that relate to compensation arrangements beginning on the relevant implementation dates in 2013 (for new clients) and 2014 (for existing clients).

To assist Dealer Members to understand and comply with these and all other obligations they have under IIROC Rules, specific considerations and recommendations regarding the choice between commission- and fee-based accounts are discussed below.

Commission vs. fee-based: general considerations

Commission- and fee-based accounts each involve different advantages and disadvantages for clients, and these basic advantages and disadvantages should be the starting point for any regulatory analysis.

As noted above, in a commission-based account, the client is charged a commission each time a trade is executed. For the client, the advantage of this arrangement is that the service(s) received in exchange for the commission paid is concrete and specific—a given trade, which is typically based on a specific recommendation by the advisor. Moreover, when the client's account is inactive—either because no recommendation has been made or because the advisor has recommended a long-term hold on a security—the client incurs no cost.

In contrast, fee-based accounts charge a set percentage of account value or, in rarer cases, a flat fee, for an ongoing service, regardless of the number of trades that occur in the account over the specified period. The advantages that fee-based accounts may offer include:

- fostering a greater alignment of interests between the investment advisor and the client, given that, if the advisor's compensation is based on a percentage of the value of the assets in the client's account, it is in the best interest of both the client and the advisor to maximize the value of those assets;
- reducing the likelihood of certain harmful sales practices, such as churning or making recommendations unduly influenced by compensation, since such practices will not increase the investment advisor's compensation, but will expose them to liability and regulatory risk;
- increased transparency of the cost of services and advice provided to the client insofar as fee-based charges make it more apparent to clients that they are compensating their advisor for all services, including those that do not necessarily result in trades (e.g. a recommendation to continue holding

[14] See IIROC Notice 12-0109, Rules Notice – Guidance Note, *Know your client and suitability – Guidance* (Mar. 26, 2012), online: <http://docs.iiroc.ca/DisplayDocument.aspx?DocumentID=D21B2822BCC34B2F8C7F422C3B3C1DE1&Language=en> at 1, 5.

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a security or maintain assets in cash—referred to informally as a "do nothing" recommendation). In a commission-based account, clients may mistakenly assume that these services are provided for free, even though they may be built into the commission structure, if provided at all; and

- enhanced predictability of client charges.

Whether a commission- or fee-based account is suitable for a particular client will depend on the specific circumstances and informed preference of each client. To the extent that there is a shift towards fee-based accounts, Dealer Members will need to adjust their supervisory procedures where such procedures were primarily designed to address commission-based accounts.

As described in greater detail below, Dealer Members, their supervisory personnel and Registered Representatives must take appropriate steps, in accordance with IIROC Dealer Member Rule 1300.1, to ensure that every account opened is suitable for the client in question. In addition, pursuant to IIROC Dealer Member Rule 2500, Dealer Members and their supervisory personnel must ensure that every account is adequately monitored on an ongoing basis to detect any improper trading activity. Dealer Members are also expected to implement policies and procedures that will enable them to ensure that:

- an account, whether commission- or fee-based, remains suitable for the client going forward; and
- double charging, which can be of particular concern in fee-based accounts, is prevented.

Set forth below are specific considerations to assist Dealer Members and other regulated persons in meeting these regulatory expectations.

Specific issues to consider

Assessing suitability at account opening

Pursuant to paragraphs (p) and (q) of IIROC Dealer Member Rule 1300.1, Dealer Members and Registered Representatives must use due diligence to ensure that every order accepted and trade recommended for every account is suitable for the client in question. As noted in the recent suitability guidance referred to above, Dealer Members are expected to assess the suitability of the account type as part of their Rule 1300.1 obligations, and such obligations should extend to the account's compensation structure, since it can be seen as a significant aspect of account type.

As with all investment-related decisions, whether a commission-based or fee-based account will be a suitable option for a given client will depend on the essential facts and circumstances relating to that client. Dealer Members should take into account the following factors when assessing the relative suitability of commission-based versus fee-based accounts on behalf of a given retail client:

- whether the client engages in, or plans to engage in, frequent trading of account positions or, instead, tends to be a conservative, "buy-and-hold" investor;
- whether the client typically makes—or plans to make— frequent requests for investment advice or other enhanced services (e.g. quarterly meetings, monthly portfolio summaries, ongoing

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distribution of research reports, financial planning) that go beyond making and executing suitable investment recommendations for the client;

- the client's time horizon, i.e. whether the client expects to hold the account for a long period of time or, instead, expects to draw on the funds in the account or close it within a relatively short period of time;
- whether the client tends to invest primarily in assets that have "trailer" or other embedded fees, such as certain mutual funds, fixed income products, and new issues (e.g., initial public offerings), assuming the client was previously aware of the existence of such fees;
- whether the client is comfortable with the prospect of variable charges over time, stemming from a varying amount of activity in the account, or, rather, places a premium on certainty and consistency of fees or charges; and
- the relative size of the assets in the account, which should be used to weigh the other factors noted above, especially when both a flat fee and a percentage-fee-based option are offered, since account value may weigh either in favour of—or against—switching a client out of a commission-based account, depending on the particular fee structure being considered and in light of other relevant factors. For example:
    - a client with a smaller account may be better off in a percentage-based fee account, as compared to either a flat fee or a commission-based account, assuming a certain minimum number of trades will be executed over the relevant period;
    - a client with a larger account value who intends to do the same number of trades may be better off with a flat fee account, as compared to both a percentage-based fee and a commission-based account;
    - a client who intends to trade infrequently may be better off in a commission-based account, as compared to both a flat and percentage-based fee account, unless the account size is relatively small, in which case a percentage-based fee may be more economical for the client.[15]

In addition, some Dealer Members require a minimum account value in order for a client to be eligible for fee-based services, while others offer a minimum (i.e. flat) fee for accounts whose value is below a specified threshold. Given the complexity of outcomes that may result from differing compensation options and the interaction of various suitability factors, Dealer Members are encouraged to adopt a holistic approach to assessing the suitability of the specific compensation structures that they choose to offer. Furthermore,

[15] IIROC recognizes that the account offering the lowest cost will not necessarily be the only suitable account type for a given client. For example, a client may prefer to incur a slightly higher charge in a fee-based account (as compared to the charges she would incur in a commission-based account) for other reasons, including enhanced services, a superior quality of advice or greater certainty and consistency of cost. In such circumstances, the Dealer Member should document that the client opted for a fee-based account, as well as the factors that led to that decision.

Dealer Members are reminded of their obligation under existing Rules to have in place policies and procedures that adequately weigh all of the relevant factors, including but not limited to those listed above, while treating all customers honestly, fairly and in good faith, regardless of account value.

As a general principle, we expect that a Dealer Member or individual adviser will only move a client from a commission-based account to a fee-based account (or vice-versa) when such a change in service offerings is demonstrably beneficial to the client. The absence of any demonstrable benefit, depending on the facts and circumstances of the case, may give rise to regulatory scrutiny and, in more extreme cases, disciplinary action.

In light of the foregoing, best practices suggest that Dealer Members should document the specific factors that establish the suitability of a new commission- or fee-based account at the time that it is opened, and where the client is being switched from one account type to another, the factors that led to the transfer.

Disclosure

Pursuant to the CRM relationship disclosure obligations that will be become effective in 2013 (for new clients) and 2014 (for existing clients), firms will be required to ensure that every client is fully informed of the various types of accounts available, including all of the variants of commission- and fee-based compensation structures that the Dealer Member offers and the differences in the features, services provided and functioning of each type of account.[16] In the interim, as a best practice, we encourage Dealer Members and Registered Representatives to provide clear and complete information about account types and charges to new and existing clients and to begin preparing for the introduction of the new CRM rules.

Dealer Members have a degree of flexibility with regard to the format of their disclosures. For example, the information required to be disclosed can be communicated to the client within the new account application form itself, or in a separate disclosure statement. At a minimum, the disclosure should include a "plain language" explanation of the method for calculating commissions or fees associated with each type of account, as follows:

(1) <u>For a commission-based account</u>

The disclosure should consist of:

- a commission list that identifies the charges associated with each type of transaction (e.g. dollar amount, percentage of the value of the securities purchased or sold); and
- a list of any other fees or charges, such as account maintenance fees, fees for failing to maintain a minimum balance, account transfer fees, account inactivity fees, wire transfer fees, "finder's fees," referral fees or other hidden fees or compensation.

[16] See IIROC Notice 12-0107, *supra* note 7, at 2-3, 16; see also IIROC Dealer Member Rule 3500.5(2)(a), (f)-(g).

(2) For a fee-based account

The disclosure should indicate:

- how the fee is calculated (e.g. a percentage of assets or a flat annual fee);
- the frequency with which the fee will be charged (e.g. monthly, quarterly, annually);
- if applicable, the maximum number of trades per year allowed in the fee-based account, as well as the commission that will be charged for any additional trades;
- the services that may be offered with fee-based accounts, as well as any applicable conditions or restrictions on these services and any additional fees that may apply (e.g. minimum balance fees, etc.); and
- whether different asset classes will be subject to different fees or service offerings (e.g. equities, options, fixed income).

If the disclosure is contained in a separate disclosure document, rather than the new account application form, a best practice would be to require the client to sign this separate disclosure document.

IIROC staff are aware of proposals recently published by the CSA regarding cost disclosure, performance reporting and client statements. See Notice and Request for Comment on Proposed Amendments to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* and to Companion Policy 31-103CP *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (June 14, 2012) (2nd Publication), *Cost Disclosure, Performance Reporting and Client Statements*, (2012) 35 OSCB 5429, online: <http://www.osc.gov.on.ca/en/SecuritiesLaw_rule_20120614_31-103_proposed-amendments.htm>. The CSA's proposals are, in some ways, more prescriptive than the guidance set forth herein, for example, with respect to the specific manner in which disclosures to retail clients of embedded (or "trailing") commissions and commissions on fixed-income transactions are to be made. See *ibid.* at 35 OSCB 5431-32. Nevertheless, we believe that the proposed requirements are fully compatible with the general principles regarding disclosure set forth above, and we recognize that this Guidance Note must be interpreted in accordance with any current or future regulations or laws concerning disclosure applicable to our Dealer Members.

Account Supervision

Pursuant to IIROC Dealer Member Rule 2500(III)(B), all retail accounts of a Dealer Member must be reviewed to ensure compliance with all regulatory obligations. For Dealer Members with multiple business locations, reviews are expected to be conducted on both a daily and monthly basis, at both the branch and head office levels. See IIROC Dealer Member Rule 2500(IV).

When supervising traditional commission-based accounts, the Rules expressly allow a Dealer Member to carry out its duty to conduct monthly reviews by adopting commission-based triggers. See IIROC Dealer Member Rule 2500, paras. (IV)(B)(2) and (IV)(D)(1).

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In contrast, when dealing with fee-based accounts, alternative methods for selecting and reviewing accounts must be adopted because the distinct compensation structure of fee-based accounts means that traditional (e.g. dollar amount) commission thresholds may not be triggered in appropriate cases or, in the alternative, may be triggered too often, thus creating inefficiencies in the supervisory process.[17]

As a general matter, in accordance with IIROC Dealer Member Rule 2500, supervisory procedures for all accounts—both commission- and fee-based—must be reasonably designed to achieve compliance with IIROC Rules and all other laws, regulations and policies applicable to the Dealer Member, and may be risk-based. Notwithstanding the differences between fee-based and commission-based compensation structures, many of the same regulatory concerns may arise with regard to both account types. Policies and procedures should be designed to enable the Dealer Member to detect improper activity occurring in any account—whether commission- or fee-based—including unsuitable transactions, trading in restricted securities, conflicts of interest, unauthorized trading, outstanding margin calls, front running and manipulative or deceptive trading, among others.

Many of the specific procedures identified in IIROC Dealer Member Rule 2500 were primarily designed with commission-based accounts in mind; consequently, IIROC expects Dealer Members to make use of those specified procedures when supervising commission-based accounts. With fee-based accounts, however, as noted above, Dealer Members are required to make appropriate adjustments. In the normal course, the following factors should be monitored and would be expected to trigger fee-based accounts for review, pursuant to the requirements of Rule 2500, and clause (III)(B)(2) in particular:

- a given percentage change in account value;
- a frequency of trading or account turnover rate below or above a specified threshold;
- certain high-risk trading activities (e.g. excessive leveraging through margin, purchasing investments with greater risks than the client's stated risk tolerance);
- the presence of unusual or excessive supplemental charges (i.e. charges applied in addition to the percentage-based fee on the account); or
- insufficient documentation reflecting the enhanced services normally associated with a fee-based account.

The triggers listed above are simply intended as guidelines and are non-exhaustive. Dealer Members must exercise judgment, based on the unique facts and circumstances of their business, to design and maintain

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[17] This principle is expressly set forth in IIROC Dealer Member Rule 2500(III)(B)(2), which provides that:

> Review procedures must cover all accounts. Where a Dealer Member offers both commission and fee-based accounts, it cannot select accounts for review solely on the basis of commission levels; it must also have a procedure for selecting fee-based accounts for review.

appropriate supervisory procedures for both commission- and fee-based accounts.

Ongoing review of compensation structure suitability

As a best practice, Dealer Members should from time to time verify the suitability of their clients' existing accounts and, in appropriate circumstances, remind clients of the other compensation arrangement option(s) that may be available. Absent unusual circumstances, it would be reasonable to conduct such a review annually; however, more frequent reviews may be warranted in some cases. For example, a change in client circumstances, such as a change in trading activity, net worth, risk tolerance or investment objectives, could warrant a timely review to determine whether an existing commission- or fee-based account continues to be suitable. In particular, Dealer Members should refer to the new mandatory suitability assessment triggers adopted as part of CRM and, starting on the relevant effective date, should begin to include a review of the client's account type and compensation structure as part of any suitability analysis triggered by one or more of the events specified in the new rule.[18]

If a Dealer Member determines that a client's current compensation structure is no longer suitable, the Dealer Member should take action to place the client in a more appropriate type of account as soon as possible.

Double Charging

Some investment products, including certain mutual funds, fixed income products and new issue securities, have fees built into them. These fees are separate from those charged directly to the client by the Dealer Member in connection with their account, be it a commission- or fee-based account. In many cases, Dealer Members and their employees subsequently receive a share of these embedded fees.

In a commission-based account, the regulatory concern that arises from embedded fees and so-called "double charging" is less acute because, in many cases, no account-related commission is charged (in the case of mutual funds, in particular) or the commission is a relatively small amount that is capped (i.e. it will not accumulate over time). Nevertheless, even in commission-based accounts, Dealer Members are expected to ensure, by making adequate disclosure to their clients, that their clients are fully apprised of the true costs associated with their investment choices, including any embedded costs.[19]

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[18] The new triggers, which become effective on September 26, 2012, are: (1) securities are received into the client's account by way of deposit or transfer; (2) there is a change in the Registered Representative or portfolio manager responsible for the account; or (3) there is a material change to the client's life circumstances or objectives that has resulted in a revision to the client's "know your client" information as maintained by the Dealer Member. See IIROC Notice 12-0109, *supra* note 14, at 8; see also new IIROC Dealer Member Rule 1300.1(r) (effective September 26, 2012).

[19] Dealer Members are reminded of the newly-adopted CRM disclosure obligations mentioned above (see *supra* note 16 and accompanying text), which will require proper disclosure of all charges, including embedded fees, beginning in March 2013 and March 2014 for new and existing clients, respectively. See IIROC Notice 12-0107, *supra* note 7, at 2 ("Pursuant to the requirements in new IIROC Dealer Member Rule 3500, every Dealer Member will provide its retail clients with the following information regarding the relationship they are entering into with the client: ... a description

With a percentage fee-based account, the client is not only paying an embedded charge, but also an ongoing fee based on a percentage of the value of the security, so long as the security is held in the account. Moreover, when fees are embedded or paid by a third-party product provider to the investment advisor, there is a concern that clients may not be aware that such fees exist and are ultimately being passed on to them. To address these concerns, when dealing with a client holding a fee-based account, our understanding is that it is currently standard industry practice to avoid double charging for embedded-fee securities by:

- offering the client fixed income assets at the prevailing market price (i.e. free of any mark-up by the Dealer Member itself);
- recommending mutual funds that carry no trailer fees (often referred to as "F-class" mutual funds) and other no-fee investments when they are suitable alternatives to investments with embedded fees; and/or
- rebating or adjusting account fees (for example, by treating the asset as ineligible for fees) to offset embedded fees.

Depending on the facts and circumstances, a failure to observe any of these practices could be considered a violation of one or both of IIROC Dealer Member Rules 29.1 and 1300.1(o).

Moreover, when a client holds both a commission and a fee-based account, the Dealer Member should ensure that trades are directed to the appropriate account. It would, for instance, be inappropriate—and possibly a violation of IIROC Dealer Member Rule 29.1—to charge a client a commission on the purchase of a security and subsequently earn an additional fee by transferring that security into a fee-based account.

Finally, as part of their general supervisory obligations, Dealer Members are reminded that they must maintain policies and procedures that allow them to flag and prevent improper double charging in all

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of all fees, charges and costs associated with operating the account and in making or holding investments in the account...."); see also *ibid* at Attachment E ("Transition periods and implementation date"). As staff noted in a Guidance Note issued on the same day as the implementation of CRM was announced:

> Consistent with the requirements of National Instrument 31-103..., IIROC staff expects the discussion of account operation and transaction fees/charges will include all charges a client may incur during the course of acquiring, selling or holding an investment product position, including amounts to be paid indirectly to the Dealer Member by the client. For example, mutual fund fees/charges disclosure should include a discussion of the management expenses that are deducted from fund performance by the mutual fund manager and the types of fees/charges, such as trailing fees, that may be paid to the Dealer Member by the mutual fund manager from these collected management expenses.

IIROC Rules Notice, Guidance Notice 12-0108, *Client Relationship Model – Guidance* (Mar. 26, 2012), online: <http://docs.iiroc.ca/DisplayDocument.aspx?DocumentID=3785CCE9B029435BB11D401FD5154D9E&Language=en> at 3.

accounts, whether commission- or fee-based.

Conclusion

IIROC Rules currently enable Dealer Members to offer retail clients a choice among various compensation arrangements, including commission- and fee-based accounts, but any compensation arrangement being offered to a client must be suitable for them, and Dealer Members may need to adjust long-standing supervisory practices that were designed for commission-based accounts so that current practices are appropriate and effective for fee-based accounts as well. To achieve these objectives, Dealer Members must ensure that proper procedures are in place to:

- assess the initial suitability of each account opened, taking into account the factors applicable to commission- and fee-based accounts, in particular;
- provide proper disclosure to clients about the features of both commission- and fee-based accounts and how they differ from one another;
- effectively supervise the ongoing activity in both commission- and fee-based accounts, as applicable; and
- prevent the double-charging of clients as a result of embedded commissions or improper transfers between commission and fee-based accounts.

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