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Investment Industry Regulatory Organization of Canada
Organisme canadien de réglementation du commerce des valeurs mobilières

IIROC NOTICE

Rules Notice
Guidance Note
Dealer Member Rules

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Managing Conflicts in the Best Interest of the Client – Status Update

The Canadian Securities Administrators recently published CSA Staff Notice 33-318 summarizing the results of a survey conducted in 2014 on compensation arrangements and incentive practices used by firms (the CSA notice). As noted in the CSA notice, IIROC and other regulators have also been doing work in this area.

Specifically, on April 6, 2016, IIROC published Notice 16-0068 – *Managing Conflicts in the Best Interest of the Client*. It affirmed our intention to strengthen compliance by our Dealer Members with the best interest requirements of our Conflicts of Interest rule, with particular focus on the management of compensation-related conflicts. We then undertook a comprehensive review to gather more detailed information on how firms identify, monitor and manage compensation-related conflicts.

Our review covers a wide range of business models and products. The purpose of this notice is to provide an update on the status of the review and a high-level overview of various themes that have emerged to date. As we continue our review, we will take appropriate regulatory action as required.

The Review

The review focused on three different aspects of compensation-related conflicts:

- product shelf and account types offered
- compensation arrangements
- supervision issues.

We are reviewing 20 firms representing a cross-section of the IIROC membership[1]. In addition to responding to specific review questions, firms also provided supporting documents.

Given the diversity of selected firms, it was not surprising that we identified a variety of different compensation arrangements and approaches to identifying, monitoring and managing compensation-related conflicts. To a certain extent, this variation is normal and acceptable. Rule 42 is principle-based and allows firms considerable discretion in the way they choose to deal with identified conflicts. The overarching standard of Rule 42, however, is that:

- the firm's representatives must address all material conflicts – whether existing or potential – in a manner that *is consistent with* the best interest of the client
- recognizing that firms must balance the interests of multiple clients simultaneously, the firm must address all material conflicts in a manner that *considers* the best interest of the client.

We scheduled follow-up meetings with compliance, supervisory and business staff of each respondent firm to delve deeper into any issues identified in our initial review. These targeted reviews are ongoing and will be completed by year-end.

Themes

Our analysis has found some examples of the practices noted in the CSA notice. In early 2017, we plan to publish a notice providing a detailed summary of our findings. Themes that have emerged to date include some best practices, some areas of concern, and some good controls.

We have identified best practices in three key areas:

1. Enhancements to Daily and Monthly Supervision – Various firms have implemented enhanced monitoring that identifies questionable activity in accounts. These reviews go beyond a simple churning test and often involve the identification of accounts with excessive fees and commission relative to the overall size of the account.

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[1] We selected large integrated firms as well as small and medium-sized retail firms. Some firms offer a full range of products including debt, equity, mutual funds and prospectus-exempt products, whereas others focus primarily on proprietary products. Business models based on a principle-agent structure are represented. The nature of the client base also differs; some firms have significant entry-level investment-size thresholds whereas in other cases the minimum investment is much lower. Services range from commission-based advisory to fee-based managed accounts.

2. Product Due Diligence – As part of their product due-diligence processes many firms have identified optimum products within certain asset classes, based on a holistic consideration of multiple factors including performance, risk factors, investment objectives, costs and fees. Representatives are provided with this information to help them recommend the most appropriate products.

3. Staff Training – Some firms have implemented compliance training programs for representatives on client best interests and compensation conflicts.

Areas of concern include:

1. Fee-Based Accounts – Many firms provide a higher payout to representatives for fee-based revenue versus commission-based revenue. This could act as an incentive for representatives to favor moving clients into fee-based accounts even when it would not be in the best interests of such clients. Another concern involves commission paid for selling new issues. The additional financial incentive of new-issue commissions may act as an incentive for representatives to focus inordinately on new issues even in cases where such investments would not be suitable for certain clients.

   We note that a number of firms impose restrictions on new-issue commissions in fee-based accounts, and have implemented special monitoring to this effect. Many firms have also implemented effective processes for ensuring there is no double-charging within fee-based accounts. For example, restricting mutual funds to F-class funds, prohibiting mark-ups on fixed-income products, and backing out certain assets from the fee calculation are controls we observed.

2. Proprietary Products – For firms that sell non-arm's-length and third-party products, certain cases were noted where the compensation grid payout was greater for the non-arm's-length product than for comparable third-party products. We also noted more subtle forms of bias that could indirectly motivate representatives inappropriately to favour related-party products. Examples include bonuses based on the overall percentage of fee-based revenue, and equity ownership programs in related-party issuers.

3. Supervision – While motivating representatives to generate revenue is normal practice, some compensation plans can result in sales behavior that is not in the best interests of clients. Examples include firms where a supervisor or branch manager's compensation is tied to the sales and revenue targets of representatives whose conduct the supervisor or branch manager is responsible for reviewing. It is critical that firms identify potential weakness in their compensation programs and implement compensating controls to ensure that they are not used to the detriment of clients. Although some firms have implemented effective monitoring programs, others have not given sufficient attention to this critical area. Some firms should consider changes to their program or their compensation plan to avoid these compensation-related conflicts.

Next Steps

We are aware that our work in this area is being conducted against a backdrop of significant regulatory activity in related areas, including the CSA's consultation on a potential best interest standard as well as more targeted reforms. We also anticipate that implementation of the fee- and performance reporting requirements of the Client Relationship Model (CRM2) may result in changes to industry practice.

We will continue to work closely with our regulatory partners and monitor the results of all other ongoing initiatives as part of any process to introduce new IIROC rules or guidance on compensation-related conflicts. With that in mind, in the coming months we will:

- publish a notice providing a detailed summary of our findings
- determine whether guidance and/or rule amendments are needed to better address compensation-related conflicts
- take appropriate regulatory action as required
- incorporate more detailed questions from the targeted reviews into our permanent compliance test procedures so we can more closely examine compensation practices and the management of associated conflicts.

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