

**Consultation on Possible Options for the
Incorporation of Individual Representatives of
Registered Dealers and Advisers in Canada:**

Summary of Consultation Responses

June 2011

Part 1 Introduction

In June 2010, a working group of provincial/territorial government officials (Working Group) was struck to work with industry, provincial/territorial securities regulators, self-regulatory organizations and other stakeholders to explore options for the incorporation of individual representatives of registered dealers and advisers.

Currently, representatives of registered dealers and advisers are prohibited from using a corporation to offer trading and advising services to clients under provincial/territorial securities laws.

Consultation on Incorporation Options

The Working Group published a consultation paper entitled *Consultation on Possible Options for the Incorporation of Individual Representatives of Registered Dealers and Advisers in Canada* on December 20, 2010. The Consultation paper identified and sought feedback on three possible options for dealing with the incorporation issue and six specific questions related to those options. The three options included two legislative proposals establishing a statutory framework for the incorporation of individual representatives of registered dealers and advisers and a third option permitting the redirection of remuneration earned by an individual representative to a non-registered corporation.

Through this consultation, which ended February 25, 2011, the Working Group received 63 formal written submissions from a diverse range of stakeholders, including registered firms, individual representatives, insurance registrants, exempt market dealers, investor protection organizations, trade and professional organizations and self-regulatory organizations.

Those submissions ranged from short expressions of support for incorporation, responses to the questions asked in the consultation paper, a combination of general comments and answers, to the adoption of a fiduciary standard in place of the proposed incorporation model. A fiduciary standard requires an individual representative to put the customer's interests first, in contrast to the current suitability standard that requires the representative to recommend the most suitable product for the client.

Written responses have been published on the Alberta Finance and Enterprise and Québec Finance websites and can be found at:

- <http://www.finance.alberta.ca/publications/other/incorporation-sales-reps-dealers.html> [English language submissions]
- <http://www.finances.gouv.qc.ca/fr/page.asp?sectn=2&contn=401>. [French language submissions]

A list of commenters can be found in Appendix A to this report. Representative examples of the four types of submissions received can be found in Appendix B.

This document provides:

- a summary of comments received,
- a list of key themes highlighted by commenters, and
- a summary of the responses to each of the questions posed in the consultation paper.

Next Steps

The Working Group plans to report back to Ministers responsible for securities regulation across Canada early this summer on the results of the consultation together with recommendations for proceeding.

Over the coming months, the Working Group will continue to develop and refine its proposal for dealing with the incorporation issue, working with securities regulators, self-regulatory organizations, industry and other stakeholders, taking into account comments received.

This will involve further consultation on the details of an appropriate legislative model and draft legislation establishing a new statutory framework for that incorporation model.

Part 2 Key Themes from Consultation

Overview

The overwhelming majority (59 of 63) of commenters strongly supported the adoption of a statutory incorporation model. There was also near universal consensus on the critical importance of investor protection, but the majority of commenters expressed the view that investor protection need not be diminished with an incorporation model.

Many emphasized the need for a legislative model to include safeguards to ensure that the individual representative remains subject to liability claims from clients and responsible to the dealer for complying with securities laws and dealer compliance policies. Others observed that the existing principal-agent regime's contractual requirements already address investor protection and would be strengthened once supported by a statutory framework. Industry familiarity with the principal-agent regime should ensure a smooth transition to an incorporation model.

A small number of commenters expressed strong opposition to incorporation, characterizing it as "highly inappropriate and injurious to investor protection". These commenters were concerned about the potential for shielding individual representatives from personal liability for investor fraud or misrepresentation and suggested that incorporation should only be considered if there are demonstrated benefits to investors.

Along with general support for incorporation, commenters also highlighted a number of aspects for further consideration or clarification when refining a proposed legislative framework for incorporation of individual representatives of registered dealers and advisers. In this part we will set out the key themes emerging from the consultation responses. Responses to specific consultation questions are summarized in greater detail in Part 3 of this document.

Seven common themes emerging from submissions received are:

- The importance of moving forward with an incorporation proposal to resolve this long-standing issue in a timely manner as the discussion and debate on this issue have been exhaustive and it is now time to act.
- Recognition that incorporation is not a suitable alternative business structure for all, but provides an individual representative with additional flexibility and choice.

- The need for an incorporation model that is consistent with the principles outlined in the consultation paper, addresses identified regulatory and accountability issues, and ensures the protection of the investing public.
- The clear preference for a legislative incorporation model over a directed commission model.
- The importance of a consistent, harmonized approach to incorporation for all dealing and advising representatives without differentiating between representatives of the Investment Industry Regulatory Organization of Canada (IIROC), the Mutual Fund Dealers Association of Canada (MFDA) or non-self regulatory organization firms (like Québec mutual fund dealers, exempt market and scholarship plan dealers) or the products they provide.
- The need to clarify whether these corporations should be a single-purpose vehicle limited to securities-related activities or multiple purpose vehicles to accommodate a wider variety of activities (related to securities, insurance or financial planning).
- The need for further consultation on the details of an appropriate legislative model and supporting legislative framework.

International Reform - Opponents of the concept of incorporation have encouraged provincial governments to consider international developments providing for the adoption of a statutory fiduciary standard for individual representatives and changes to the compensation system, which would ban the current practice of financial product providers directly compensate individual representatives. Others have urged Canada to take the lead in recognizing that fiduciary duty is not created by statute but rather by the nature of a relationship – in this case the relationship between an investment adviser and a client.

Canada's Client Relationship Model - IIROC is in the process of finalizing its Client Relationship Model (CRM) proposal. The current CRM proposal does not propose to prohibit current remuneration practices, but instead calls for enhanced transparency and disclosure to clients. Although the CRM proposal does not expressly introduce a fiduciary standard, it would elevate the current standard of care. We received a number of suggestions relating to the CRM proposal:

- Securities regulators, IIROC and the MFDA should review international reform initiatives regarding disclosure, advisers as fiduciaries and adviser compensation and establish world class benchmarks and best practices in these areas.
- the CRM proposal should be revisited in light of that review as the CRM proposal addresses issues similar to those addressed in the US, UK and Australian reform proposals.

- any decision on the incorporation proposals should be deferred until IIROC's CRM structure has been finalized and its financial planning rules have been issued.

We also received the following questions about the incorporation model which we will consider during the next phase of this initiative:

1. Has the CRA opined on this scheme that diverts employee income to a corporation so as to minimize, avoid, or defer income tax?
2. Are there any consequences for dealers if the CRA rules against this scheme or if the employee deliberately or inadvertently files incorrect tax returns for the corporation?
3. Are trailers considered commissions or service fees (as depicted by industry participants)? Bonuses? Referral fees? Other incentives?
4. Would base salary also be transferred to the incorporated entity?
5. Will statutory deductions be made on the commissions?
6. If not, could this be taken as evidence that salespersons are really independent businesses rather than employees (and thus shield dealers from liability)?
7. Will CRA T-slips (e.g. T-4's) be made out in the name of the employee or his/her corporate tax shelter?
8. Will robust regulatory oversight of registrants, including continued unencumbered access to all relevant information, books and records be assured?
9. Will it apply to former registrants as well?
10. Could multiple owner ownership of a corporation limit access to needed corporate information in any way (e.g. a privacy shield)?
11. Are there going to be restrictions on share ownership and how will compliance be monitored?
12. Will offshore bank accounts be acceptable?
13. Are there going to be restrictions on corporation names (e.g. could they be called XYZ Financial Advisors)? If no restriction, we believe this could lead to misrepresentation issues.

14. Will differing regulatory standards between IIROC Members, MFDA Members, non-SRO members and the insurance industry lead to compliance challenges?
15. Will salesperson incorporation add to regulatory costs (which are ultimately paid by retail investors)?
16. Regarding the ASC proposal to require an annual permit from the Executive Director, will this be a complex and expensive process, or can it be modeled on the (relatively efficient) process used in the insurance industry?"
17. How would the legislative option be implemented across all jurisdictions? Will all jurisdictions agree to a standardized approach?
18. Will some provinces/territories have barriers to implementation in that they would have to make legislative or regulatory changes in advance of implementation of a legislative option and how long will this take?
19. The consultation paper proposes options that are different from that already in place for mutual fund advisers. Will there be an undertaking by regulators to adopt a consistent approach (i.e. will MFDA Rule 2.4.1 be amended to comply if a legislative option is chosen)?
20. What about registered reps who are licensed in multiple jurisdictions? Will they need to obtain a permit from each jurisdiction or only from their principal jurisdiction? One suggestion would be to provide a mobility exemption, similar to that which exists under NI 31-103, where a limited number of clients could be serviced without incurring the additional cost to obtain various annual permits.

Part 3 Summary of Responses to Consultation Questions

We asked:

1. Should governments allow a broader range of registered dealers and advisers to redirect remuneration to a non-registered corporation?

We received 46 responses to this question from a variety of registered dealers and advisers, individual representatives, self-regulatory organizations, trade associations and investor advocacy entities. A majority of commenters (35) supported allowing a broader range of registered dealers and advisers to redirect remuneration to a non-registered corporation. Their reasons for supporting the proposal to allow a broader range of registered firms to redirect remuneration to a non-registered corporation included:

- contributes to a level playing field for all financial firms and representatives across Canada
- allows for more efficient business management of expenses and payment of other staff, and better tax planning
- facilitates the mobility of talent across industry sectors
- provides additional career opportunities without disadvantaging an individual's tax position.

Nine commenters supported the adoption of a single redirection model for all representatives of registered firms (dealers and advisers) to level the playing field between IIROC firms and their representatives and MFDA firms and their representatives. Five others supported a modified redirection model. Suggested modifications included:

- requiring disclosure of the corporate name and nature of the business operations of a representative's non-registered corporation be disclosed to regulators and clients, and
- requiring the parties enter into a regulatory agreement similar to the agreement prescribed for the IIROC principal-agent model to preserve the same compliance and legal duties, responsibilities and obligations to the regulator, the dealer and the client as if the agent was an employee.

Ten commenters supported a redirection model only as an interim solution, while 11 commenters opposed a redirection model.

2. Should governments allow individual representatives of registered dealers and advisers to incorporate?

An overwhelming number of commenters (59 of 63) who addressed this question agreed that individual representatives should have the option of using a corporate structure to deliver their trading and advisory services to clients. Adding this option allows individual representatives to consider a variety of business structures and determine the most suitable option for their situation.

Many believe that the investment industry is adequately regulated, supervised and developed enough to meet the definition of a professional industry and question why investment professionals are not afforded the same right to incorporate available to service providers in the accounting, legal, medical, dental and insurance industries. The majority of commenters see incorporation as an efficient and effective business model that provides many benefits to individual representatives without eroding investor protection.

Sixteen commenters believe that allowing individual representatives to incorporate will contribute to more flexible tax and retirement planning. They also believe that an incorporation model can also help to address investment adviser attraction and retention concerns.

Seven commenters expressed frustration with the decision of provincial securities regulators in 2006 not to approve the bylaw proposal by the Investment Dealers Association of Canada (now IIROC) to allow individual representatives of advisers and dealers to incorporate.

Four investor organizations are adamantly opposed to the adoption of an incorporation model because of its negative impact on investor protection. These commenters believe the better option is to impose a fiduciary standard that requires investment firms and their representatives to put the interests of their clients ahead of their own, citing international developments in the US, UK and Australia to ban commission sales and to move to a fiduciary standard.

A common theme in those four submissions was that incorporation is incompatible with the personal liability of registrants for their conduct because of the potential to shield individual registrants from liability and weakens the system of oversight and supervision. Those commenters suggest that provincial securities regulators need to re-examine their regulatory priorities to focus on fixing the flaws in the current system to ensure and enhance investor protection.

3. If yes to question 2, which incorporation option would in your view be the most effective and balanced alternative?

Views on which incorporation option was the most effective and balanced alternative were mixed:

- 25 commenters supported option 1 (annual corporation permit system)
- 11 commenters supported option 2 (Advocis proposal)
- 1 commenter supported option 3 (remuneration redirection)
- 4 commenters supported either option 1 or 2
- 16 commenters expressed no option preference

Several commenters found the annual permit mechanism in option 1 to be cumbersome and suggested modifying option 1 to provide for the issuance of a one-time permit with notice of any changes instead.

Three commenters favored a modified option 2. Suggested modifications included adding the annual permit mechanism from option 1, more shareholder flexibility and eliminating the requirement for the corporation to obtain errors and omissions insurance.

Four commenters did not support any of the incorporation options identified in the consultation paper and encouraged provincial governments to consider instead the adoption of a fiduciary standard for all dealers, advisers and their representatives requiring them to put the rights of their clients ahead of their own.

4. Are there other provisions or options that should be considered to ensure that the use of a corporation continues to preserve the registrant-client legal relationship for both firms and individual sales representatives and provides for proper oversight of individual sales representatives by their registered dealer and adviser?

Of the 46 commenters who responded to this question, 19 stressed the need for the legislative framework for an incorporation model to ensure that there is no dilution of the liability of the individual representative or the registered firm to the clients.

One commenter believes any incorporation model should be consistent with the principles identified in the consultation paper along with two additional principles set out in its submission, address identified regulatory and accountability issues, and ensure the protection of the investing public. The same commenter also believes that a legislative option is clearly preferable to the re-direction of

remuneration option and would most efficiently and effectively level the playing field amongst individual registrants.

Another four commenters suggest imposing a statutory fiduciary duty on individual representatives and their firms to ensure they put their clients' interests ahead of their own in place of the current less stringent suitability standard.

One commenter proposed the creation of a new disclosure form for individual representatives that would include information on the individual representative's qualifications, background and responsibilities. This point of engagement disclosure for financial advisers would augment the transparency and disclosure provided by the new point of sale product disclosure for mutual fund products.

Several commenters suggested including strict restrictions on directors, officers and shareholders or imposing shareholder restrictions similar to those in other professional organizations in an incorporation legislative model.

Close to one-third (20) of the commenters told us that the proposed options described in the consultation paper represent the best available alternatives, pointing out that a great deal of research, consideration and effort has been directed at the topic of adviser incorporation by all interested parties for more than ten years without resolution. They encouraged us to "get on with it" as this represents the best opportunity to resolve the advisor incorporation issue.

5. Do you have any concerns or comments about potential income tax consequences or regulatory obstacles regarding each option?

As expected, we received mixed responses from those who responded to this question.

Two commenters suggested by allowing individual representatives to incorporate for purposes of lowering their tax burden will shift the tax burden to other tax payers. Another commenter believes that any increase in complexity will increase the regulatory burden and divert resources from regulation and enforcement which should be the regulators' primary functions.

Thirty commenters believe that both legislative options (options 1 and 2) provide the required certainty and remove the impact of potential adverse tax consequences for individual representatives.

Another commenter believes that without a legislative change, requirements in securities and tax laws cannot be reconciled in any incorporation model.

Twenty commenters agree with the consultation paper's suggestion that the redirection remuneration to non-registered corporations (option 3) could leave the individual representative open to potential tax risks.

Seventeen commenters expressed frustration with the inability of individual representatives to incorporate as it limits their access to tax planning retirement benefits associated with incorporation. Many of these commenters noted the ability to utilize the \$750,000 lifetime capital gains exemption upon selling their business would be an important source of retirement income funding.

A commenter questions why the CRA would categorize a representative's corporation as a personal service business as the CRA already permits similar business structures for insurance agents, accountants, medical professionals and realtors. The commenter notes that the CRA has principles in place that distinguish a personal service business from a legitimate corporation

Two commenters propose that the individual representative corporation should be registered. One commenter suggests this will enable better tracking of revenue by regulator of individual representatives' incomes while the other commenter notes that it will permit the corporation to receive the remuneration.

Two commenters raise concerns regarding the proposed permit regime structure contemplated under option 1. One commenter suggests complex ownership structures will make it difficult for regulators to collect fines and investors to seek restitution, while the other commenter suggests the permit regime is based on a potentially complex and expensive process and recommends it be modeled on the insurance industry permit process.

<p>6. Do you have any concerns or comments about the potential impact of the incorporation options on investor protection?</p>
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Of the 47 commenters who responded to this question, 34 believe that allowing individual representatives to incorporate would not create investor protection concerns. Reasons given to support their views include:

- the proposed options presented in the consultation paper adequately address investor protection.
- experience with the MFDA redirection model and other professional incorporation regimes have not given rise to investor abuse.
- implementing a robust statutory incorporation model that encompasses the key protections already built in and successfully proven in the principal-agent model would strengthen those existing contractual requirements.

Four commenters believe that incorporation of individuals will negatively impact investor protection and propose the imposition of a mandatory fiduciary duty of care instead.

Six commenters suggest that an incorporation framework should include safeguards to ensure individual representatives continue to remain subject to liability claims from clients and to continue to be responsible to the dealer for compliance with securities laws and compliance policies.

A commenter suggests that non-registered individuals not be permitted to be shareholders of corporations providing trading and advising services to ensure the focus remains on providing professional investment advice.

Another commenter encourages standardization of compliance requirements between mutual funds and segregated funds to eliminate tax incentive choices between insurance and securities products under the existing system.

A number of commenters believe the current raft of investment fraud is primarily related to unregistered advisers or registered advisers selling products they are not licensed or registered to sell. Establishing clear guidelines for business structures, educational and professions standards would, in their view, make it more difficult for scam artists to prey on investors.

In this regard, one commenter has recommended a further review of the CRM proposal, which addresses issues similar to those in the US, the UK and Australian reform proposals. The CRM proposal does not propose to prohibit current remuneration practices, but instead calls for enhanced transparency and disclosure to clients. Although the CRM proposal does not expressly introduce a fiduciary standard, it would elevate the current standard of care.

Appendix A

List of Commenters/Respondents

Advocis (Greg Pollock and Robert McCullagh)

Anderson, Leanne

Andrews, David (Manulife Securities Inc)

Association of Canadian Compliance Professionals (Sandra Kegie)

Bélanger, Robert

Bergeron, Dany (Financière Radisson Inc)

Boutin, Michel (Services financiers Mérici)

Butler, Keith

Canadian Life and Health Insurance Association

Canadian Institute of Financial Planners (Keith Costello)

Canaccord Genuity Corp (Paul Reynolds)

Cormylo, Bill

Cowdery, Rebecca A. and Gerhart, Marsha P. (Bordner Ladner Gervais LLP)

D'Ambrosi, Nerio

Dufour, Stéphane (Planificateur Financier)

Fair Canada

Federation of Mutual Fund Dealers

Grady, Nicholas

Hagi, Farouk

Henderson, Wesley

Independent Financial Brokers of Canada (John Whaley)

Investment Funds Institute of Canada (Joanne De Laurentiis)

Investment Industry Regulatory Organization of Canada (Rosemary Chan)
Investors Group Financial Services Inc (Kevin Regan)

Jensen, Larry

Kenmar Associates (Ken Kivenko)

Kelleway, John

Keller, Jeff

Ketler, Mark

Kudrowich, Corey

Kynock, Edward

Labbé, Jean-Francois (Investia Financial Services Inc)

Leger, Roger

Leonard, Sheila

Lewis, Robert

MacDonald, Wayne

Manitoba District Council Advisory Committee, IIROC (Corey Johnson)

Manulife Securities (Rick Annaert)

Massiccolli, Carlo (Groupe conseil privé)

McFaul, J. Herb

MGI Financial Inc (David Velanoff)

MICA Capital Inc

Mouvement des caisses Desjardins

National Bank Financial Group (Brian Davis)

Newel, Gordon (on behalf of Eric Willerth, Raymond DeVetten and Brad (David) Hinds of Navigator Wealth Management)

Nobrega, David

Ocean Securities Inc (Robinson Manson)

Paradis, Don (dcp Financial Management Ltd)

Pellegrini, Perry R

Portland Investment Counsel (Frank Laferriere) and Portland Private Wealth Services Inc.
(Victoria Ringleberg)

Powell, Jamie

Québec Association of Independent Personal Financial Advisors (Raymond Pratte and
Jean-Paul Jalbert)

Raymond James Ltd (Paul Allison.)

RESP Dealers Association of Canada (Paul Renaud and James Deeks)

Rogers Group Financial

Small Investor Protection Association (Stan Buell)

Stefanowski, Grant

Supron, Anthony

Therriault, C.P.

Turgeon, Edward P.

Weigh House Investor Services (MacKenzie, Warren)