OSC Investor Advisory Panel
c/o Ursula Menke, Chair
iap@osc.gov.on.ca

April 12, 2017

VIA EMAIL

Steve Dowling
Superintendent of Securities
Department of Justice and Public Safety, Prince Edward Island

Tom Hall
Superintendent of Securities
Office of the Superintendent of Securities, Northwest Territories

Maureen Jensen
Chair and Chief Executive Officer
Ontario Securities Commission

Kevin Hoyt
Executive Director
Financial and Consumer Services Commission

Brenda Leong
Chair and Chief Executive Officer
British Columbia Securities Commission

Stan Magidson
Chair and Chief Executive Officer
Alberta Securities Commission

Jeff Mason
Superintendent of Securities
Department of Justice
Government of Nunavut

Louis Morisset
Président-directeur général
Autorité des marchés financiers

Donald Murray
Chair
The Manitoba Securities Commission

John O'Brien
Superintendent of Securities
Office of the Superintendent of Securities, Service NL

Fred Pretorius
Superintendent of Securities
Office of the Yukon Superintendent of Securities

Paul Radford
Chair and Chief Executive Officer
Nova Scotia Securities Commission

Roger Sobotkiewicz
Chair
Financial and Consumer Affairs Authority of Saskatchewan

Mark Gordon
President and Chief Executive Officer
Mutual Fund Dealers Association of Canada

Andrew Kriegler
President and Chief Executive Officer
Investment Industry Regulatory Organization of Canada

Re: CSA, IIROC, MFDA Reports on Firm Compensation Practices

The Canadian Securities Administrators (CSA), Investment Industry Regulatory Organization of Canada (IIROC) and Mutual Fund Dealers Association of Canada (MFDA)

recently issued reports on their reviews of firm compensation practices (CSA Staff Notice 33-318, MFDA Bulletin #0705-C, IIROC Rules Notice 16-0297).

Findings of great concern
The CSA Notice was issued December 2016 and reported on a 2014 survey of direct and indirect compensation practices at six MFDA firms, eight IIROC firms, select exempt market dealers and portfolio managers. It revealed 18 different kinds of systemic, firm-wide practices that put firms' and advisors' commercial interests ahead of their clients'.

These are not isolated instances of an individual registrant's failure to properly manage a serious or material conflict. Instead, the Notice documents firm business models whose compensation and personnel policies are explicitly designed to incentivize and reward registrant behaviour that profits the firm and its employees at the expense of the client.

We do not understand how these firms can be considered compliant with current conflict of interest rules. Indeed, the CSA Notice calls the incentives which they uncovered that favour selling proprietary products a "serious conflict of interest." We would assume that other findings would also be determined as serious conflicts of interest, such as awarding professional titles based on achieving sales targets, cross-selling, higher payouts for selling deferred sales charge (DSC) funds or fee-based accounts, or tying a branch or compliance manager's compensation to the sales performance of the registrants they supervise.

The CSA survey documenting clear evidence of inappropriate practices took place in 2014. The MFDA and IIROC did not follow up with targeted reviews of their member firms until sometime in 2016. The MFDA elected to review all firms but focussed only on some of the 18 identified practices. IIROC chose to review 20 firms, ("a representative sample") focusing on three practices.

Concerns about regulatory responses
We are concerned about the regulatory responses to these serious findings.

We regret that the CSA did not reference those survey findings in *CSA Consultation Paper 81-408 – Consultation on the Option of Discontinuing Embedded Commissions*, which are directly relevant to the selling of mutual and investment fund products, in its discussion paper on embedded commissions. Commentators responding, for example, to the CSA request for comment on permitting referral fees, would have benefited from learning more about such potentially conflicted practices in these reviews.

We are also concerned about the apparent absence of timely Compliance or Enforcement follow up.

Proposed follow up:

> **CSA** - The CSA Notice concludes with a commitment to continue to analyze the findings.
>
> **MFDA** - The MFDA review commits to referring to Enforcement a small number of firms whose compensation practices regarding proprietary funds violated NI 81-

105 (a rule which has only once been enforced since its introduction in 1998). They declined to act on findings of firm compensation practices that "encourage mis-selling and unsuitable recommendations" such as higher payouts for DSC funds and referral fee arrangements, opting instead to monitor developments and participate in discussions on the CSA paper on embedded commissions. If these practices are allowed to continue while the MFDA monitors developments, investors will continue to be harmed.

IIROC - For its part, IIROC reported findings of firms providing higher payouts to representatives for fee based accounts (an issue identified in the CSA discussion paper and an abuse the IAP has expressed grave concerns about). They also discovered compensation practices where the compensation grid payout was greater for the non-arms-length product than for the comparable third-party product, as well as instances of equity ownership in related party issuers. To date, IIROC has announced no specific compliance or enforcement actions to ensure that firms change these harmful practices. Clients of IIROC regulated firms will continue to be harmed unless IIROC takes appropriate action to stop this rule non-compliance.

Conclusions

The CSA, IIROC, and MFDA reviews paint a disturbing picture of widespread, indeed endemic, firm non-compliance with current conflict of interest rules. While firms are only required to manage conflicts rather than avoid them, the evidence is clear that they are not managing them at all – they have instead established compensation programs that actually create conflicts.

Investors need a statutory Best Interest standard that will require firms to avoid conflicts of interest. Investors need regulators who will ensure that rules are enforced. Investors need to be alerted to the existence of these harmful practices.

We intend to include these comments in our response to *CSA Consultation Paper 81-408 – Consultation on the Option of Discontinuing Embedded Commissions* and look forward to discussing this with you.

Yours truly,

Ursula Menke
Chair, Investor Advisory Panel