CSA/ACVM Canadian Securities Administrators Autorités canadiennes en valeurs mobilières

CSA Staff Notice 33-318
Review of Practices Firms Use to Compensate and Provide Incentives to their Representatives

December 15, 2016

Substance and purpose

Staff from the Canadian Securities Administrators (**Staff** or **we**) published on April 28, 2016 the *CSA Consultation Paper 33-404 – Proposals to Enhance the Obligations of Advisers, Dealers, and Representatives toward their Clients* (the **Consultation Paper**), in which we outlined a framework for proposed targeted reforms relating to the client-registrant relationship. A description of potential guidance on the conflicts which may arise from compensation and sales practices is described at Appendix A of the Consultation Paper. The Consultation Paper contains a review of the CSA research related to the client-registrant relationship and indicates that we would publish a notice summarizing the results of a survey conducted in 2014 (the **Survey**) to identify the compensation arrangements and incentive practices that firms use to motivate their representatives' day-to-day behavior.

Apart from the Survey, there is significant focus and ongoing work on compensation arrangements and incentive practices by the CSA, the Mutual Fund Dealers Association of Canada (MFDA) and Investment Industry Regulatory Organization of Canada (IIROC).

This notice outlines the results of the Survey on practices that surveyed firms use to compensate their representatives, including direct tools such as commissions, performance reviews and sales targets (**compensation arrangements**), as well as indirect tools such as promotions and valuation of representatives' books of business for various purposes (for example, retirement and awards) (**incentive practices**). In addition, we set out our view of the potential material conflicts of interest that could arise from some of the compensation arrangements and incentive practices identified in the Survey.

Some of the compensation arrangements and incentive practices identified in this notice may allow a firm to more effectively manage potential or actual conflicts of interest that may arise. Firms may also have adequate controls in place to mitigate potential material conflicts of interest that could arise from their compensation arrangements and incentive practices. CSA Staff remind firms that we consider a conflict of interest to be any circumstance where the interests of different parties, such as the interests of a client and those of a registrant, are inconsistent or divergent. As explained in the Companion Policy to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations*, a registered firm's policies and procedures for managing conflicts should allow the firm and its staff to (i) identify conflicts of interest that should be avoided, (ii) determine the level of risk that a conflict of interest raises, and (iii) respond appropriately to conflicts of interest.

We may issue further guidance and/or proposed regulation related to compensation arrangements and incentive practices in light of our ongoing work on this issue and in conjunction with our review and analysis of comments received on the Consultation Paper and our consideration of proposed reforms. The Survey results are just one factor that may inform our work in this area.

Scope and methodology of the Survey

The purpose of the Survey was primarily to investigate the incentive practices in use for retail representatives serving clients in the MFDA and IIROC channels and to a lesser extent, high net worth clients in the portfolio manager/exempt market dealer channel. Firms surveyed represent some of the largest firms in the industry, in terms of assets under administration and number of approved persons.

For integrated firms (*i.e.*, an integrated firm is one that owns both distribution and asset management or product manufacturing generally), in particular, we wanted to identify all the incentive models in use across all registrant channels to understand the connections between related entities. For the independent firms, we wanted to ensure that the Survey included dealers from both the MFDA and IIROC channels. At the time the Survey was conducted, the six MFDA dealers surveyed administered 34% of assets and employed 31% of approved persons in that registration channel and the eight IIROC dealers surveyed administered 50% of assets and employed 38% of approved persons in that registration channel. There were a further 10 portfolio manager firms included in the Survey which combined had $238 billion in assets under management, $45 billion of which was managed directly on behalf of individuals.

Survey Results

1. Certain referral arrangements

Some firms use one-time or ongoing payments as an incentive for representatives to pass on business to related and/or third party financial service providers. Practices among surveyed firms ranged widely and included receiving one-time and ongoing (in some cases perpetual) referral fees and receiving both securities and non-securities related referral fees, including referral fees on mortgages, investment loans and insurance.

This practice may encourage representatives to search through their existing books of business to find those clients that could be sold the targeted product or service whether they need it or not. In the case of related party referral arrangements, it may encourage representatives to send their clients to another arm of their firm, even when third party product and/or service options may be more suitable. It may also encourage representatives to shift clients to more profitable business lines within the firm with little or no benefit to the client.

2. Compensation heavily weighted towards sales activity and revenue generation

These types of practices include the following:

100% variable pay based on commission/fee revenue

A representative’s compensation is based entirely on the commission or fee revenue that the representative generates for the firm.

Sales bonuses greater than 100% of base pay

Bonuses are so large relative to base pay that the compensation system essentially functions as a 100% variable pay arrangement.

Unbalanced scorecards (sales/revenue metrics >50%)

Scorecard compensation arrangements that tie a high weight of total compensation, either directly or indirectly, to sales or revenue targets so that the compensation system essentially functions as a 100% variable pay arrangement.

These practices may encourage representatives to generate revenue as quickly as possible to secure the benefit, which may encourage representatives to focus on the easiest route to reach the target (i.e., to focus on what is easiest to sell, what generates the most revenue, what they can sell most of), rather than what is suitable for the client. The focus may be on generating revenue for the firm and representative rather than generating value for clients. Staff note these types of compensation arrangements are often associated with unwanted representative behaviours such as churning, the sale of unsuitable products or the sale of suitable products in unsuitable amounts.

3. Professional titles tied to sales or revenue targets

Firms may assign professional titles (e.g., vice president, senior representative, specialist) to representatives based on their ability to reach certain sales and revenue targets.

This practice may encourage representatives to focus on the easiest route to reach a target (i.e., to focus on what's easiest to sell, what generates most revenue, what they can sell most of), rather than on what is suitable for a client, particularly as representatives get close to the target. Also, when the benefit confers a title to the representative (e.g., President's Club member), it could be misconstrued by the client as a measure of skill level, experience or quality, rather than a measure of sales activity, which may inappropriately increase client trust in the representative.

4. Representative bonuses (no set bonus criteria)

Some (or all) of the representative's bonus is set at the discretion of a manager, business line head or firm central committee. There are no set criteria for the distribution and amount of the bonus paid. In some cases, bonus criteria change substantially from year to year.

This practice may allow a firm flexibility to give greater bonuses to representatives that have demonstrated positive, client-focused behaviours that have not been captured or are not easily captured by other performance measures. We acknowledge that some firms have put in place a discretionary bonus structure for business reasons (e.g., to provide the firm with more flexibility to manage how much it pays its representatives from year to year depending on the firm's financial success); however, discretionary bonuses that provide very little transparency about the criteria used to award the bonus to the representative may be used to encourage practices that create serious conflicts of interest for the representative.

5. Monetary and non-monetary incentives to favour proprietary products

These arrangements favour proprietary products over third-party products whether through higher payout rates, bonuses, increased revenue recognition or through other forms of additional compensation. Only integrated firms reported these practices. Some firms reported paying their representatives a higher grid payout rate for all their proprietary mutual funds while others paid a higher rate only for a subset of their funds. Other firms based a part of representatives' annual bonus on the performance of their business unit, which included both distribution and asset management. Other firms also reported annual performance review processes that seemed to focus on representatives' activity vis-à-vis the sale of proprietary products over and above their ability to generate revenue for the firm generally.

These practices create a serious conflict of interest. These practices create an incentive for representatives and the firm to drive sales of proprietary products in order to maximize the firm's profits, which can result in inappropriate advice and inferior client outcomes. In addition, with respect to the distribution of mutual funds in particular, some of these practices may contravene the provisions of Part 4 of National Instrument 81-105 – *Mutual Fund Sales Practices*.

6. "First past the post" incentives

Representatives receive monetary and non-monetary compensation that is determined by the representatives' revenue or sales rank within the firm over a set time period or through a representative being one of a limited number to reach a revenue or sales target within the firm (e.g., bonuses, increased payout rates, recognition trips/conferences tied to being in the top percentage in terms of revenue generation, President's Club membership). Integrated firms were more likely to report using this practice than independent firms.

This practice may encourage representatives to increase sales and generate revenue as quickly as possible to secure the benefit. This introduces or increases the conflict between clients' long term needs and firms' short term revenue and profitability targets. Also, when the benefit confers a title to the representative (e.g., President's Club member), it could be misconstrued by the client as a measure of skill level, experience or quality, rather than a measure of sales activity, which may inappropriately increase client trust in the representative. This practice may also encourage representatives to focus on the easiest route to reach the target (i.e., to focus on what is easiest to sell, what generates the most revenue, what they can sell most of), rather than what is suitable for the client.

7. Non-neutral grids

Representative grid or other variable compensation payouts that differ depending on the product or service sold to the client (e.g., higher grid payout rates for initial public offerings, third party mutual funds included on the firm's recommended list, fee-based accounts, new clients).

This practice may encourage representatives to promote certain products and services over others, or in the case of higher payout rates for new clients, encourages representatives to favour certain clients over others, based on their firm's priorities rather than a client's needs. This practice may encourage representatives to sell products that are unsuitable or to sell suitable products in unsuitable amounts.

8. Investment amount incentives (ticket size tiers, minimum amounts)

The representative's compensation is tied to the size of the investment made by the client at a point in time (e.g., through investment minimums or grids that differentiate payout rates by ticket size tiers). As a result, representatives that generate the same overall revenue, but do so with clients who invest in smaller increments, earn less.

This practice may create a conflict of interest by encouraging the representative to recommend that the client invest or save more whether they need to or not; to concentrate their investment into a single product; or, to adjust the timing of their investment to increase the size of each trade. This practice may encourage the representative to recommend suitable products in unsuitable amounts.

9. Cross-selling incentives

This incentive practice is based on the range of products sold, including bonuses for reaching certain product mix targets (securities and non-securities financial products) and penalties for selling only one product type. All registrants who reported using this arrangement were part of an integrated firm.

This practice may encourage, and in the case of penalizations requires, representatives to push products and services that a client may not need or that are not suitable. Representatives are typically only compensated for cross-selling products offered by related entities. Even when the need may be valid, the client may be better served by utilizing unrelated products and services.

10. Manager compensation tied to staff sales/revenue targets

Compensation arrangements where a material portion (in some cases the majority) of the manager's pay is tied to the sales and revenue targets of his or her staff.

A manager may not be able to properly oversee staff or to appropriately evaluate conflicts when the manager is compensated in this manner. This practice may persuade managers to encourage their staff to focus on those activities that maximize the manager's compensation, rather than on those activities that serve the client's interest, even if it results in the sale of unsuitable products.

11. Changes to representative grid minimums, tiering and/or payout rates

This incentive practice involves increasing grid minimums, grid tiering or making other changes to the grid payout rates (e.g., lowering payout rates for the lower tiers, increasing payout rates for the higher tiers) in order to meet firm revenue and profitability targets.

This incentive practice may encourage representatives to no longer service those clients from whom they cannot generate more revenue. This practice may also encourage representatives to generate more revenue from their existing books of business in order to maintain the same levels of compensation and increasing production, which could lead to inappropriate behaviours such as churning or sales of unsuitable products.

12. Group sales/revenue targets

Representatives' compensation is tied to team and/or branch sales and revenue targets.

While this incentive practice has the merit of potentially encouraging team work, it may result in too much weight being put towards a firm's rather than the client's goals. Group goals may in some cases also have a target product mix or proprietary product focus. This may encourage team members to push lagging members to generate more sales and revenue, providing further incentives for the representative to focus on the team's (and by extension the firm's) goal at the expense of the client's interest or suitability.

13. Retroactive compensation increases

Representatives receive a retroactive increase in their previous grid payouts or other forms of compensation when they reach a certain revenue or sales target.

While the representative gets an increase in the payout received on previous sales service, the client who received that service gets no equivalent retroactive added value. This practice may encourage representatives to increase sales and generate more revenue for the firm as a revenue or sales target approaches. This may lead them to focus less on what the client needs and more on the revenue needed to trigger an increase. This may encourage representatives to focus on the easiest route to reach the target (i.e., to focus on what is easiest to sell, what generates most revenue, what they can sell most of), rather than on what is suitable for the client.

14. Accelerator (stepped payments)

Representatives receive higher payout rates for sales or revenues generated over a certain target over a certain fixed period of time. This arrangement is often used for new sales awards and to determine limited bonus rates on top of regular grid payout rates.

This practice may encourage representatives to try to get all sales or revenues in before the end of the payout period, which may lead to the timing of investments becoming geared to the representatives' compensation rather than the clients' needs. This practice may also encourage representatives to generate revenue as quickly as possible to secure the benefit, which may encourage representatives to focus on the easiest route to reach the target (i.e., to focus on what is easiest to sell, what generates the most revenue, what they can sell most of), rather than on what is suitable for the client.

15. Product and/or service specific promotions and competitions

Some firms set up competitions to encourage representatives to sell certain types of products or services.

The primary focus of the competitions is to provide incentives to representatives to sell products and/or services that are a priority for their firm rather than a priority for their clients. The practice may encourage representatives to promote products and services that the client does not need.

16. Revenue recognition biases

The amount of representatives' revenue credited to the grid varies depending on the type of product sold (e.g., proprietary versus third party products).

This practice may encourage representatives to favour products and services in their recommendations to clients that credit more revenue to the grid.

17. Lock-in incentives

Firms establish sales or revenue targets that lock in higher compensation rates in subsequent periods if representatives meet the target (e.g., through future bonus, grid payouts or revenue recognition rates).

This practice may encourage representatives to increase sales or generate revenue as they approach the required targets. This may increase the potential conflict between the client's needs and what the representative needs to earn to move up to the next tier on the grid. This practice may encourage representatives to advance the timing of clients' investments so that the representatives can be credited during the benefit determination period or to focus on the easiest route to reach the target as it gets close rather than on what is suitable for the client.

18. Deferred compensation

Incentive practices include a deferred component of total compensation for one or more years. This typically includes such things as deferred cash and equity awards (restricted and performance shares or units). This practice encourages representatives to take a long term focus and helps the firm minimize reputational risk. It allows for a credible threat of clawback if representatives engage in inappropriate sales practices.

Staff notes that this incentive practice does not always align the representative and client interests. Depending on the type of deferral arrangement (e.g., restricted share units) in place, it may encourage a long-term firm rather than client focus. For example, deferred compensation that is tied to firm profitability may encourage the representative to recommend proprietary over third party products, which may not be suitable for the clients.

19. Capped or decreasing incentives (fee capping)

These incentive practices are designed to equalize compensation (and minimize conflicts) across the product shelf such as through caps on embedded commissions. In addition, they are designed to limit and/or temper representatives' incentive to focus on revenue rather than focus on the client such as through grid payouts that increase at a decreasing rate as the rate of activity increases.

20. Qualitative client feedback

Under this arrangement, variable compensation is based on the quality of client feedback (e.g., through client surveys, net promoter scores, satisfactory client outcome). This practice directly ties the representative's compensation to the client experience.

21. Rolling sales/revenue targets

Representatives' sales and revenue targets are based on rolling, rather than fixed, time periods. Relative to fixed time period targets and other practices such as retroactive and lock-in incentives, rolling targets reduce some of the drive given to representatives to make sales or otherwise book revenues before a set target date.

22. Risk based clawbacks

The firm has policies in place to clawback or reduce deferred compensation if it was generated from activities that have been deemed high risk to the firm. This incentive practice seeks to reduce a representative's incentive to engage in activities that the firm has deemed high risk or that the firm is likely to deem high risk in the future.

23. Independent compliance staff compensation

Compensation of compliance staff is not tied to the sales or revenue targets of representatives, the branch or the business line that compliance staff oversees. The separation, or independence, of compliance staff compensation encourages effective oversight of representative activities and reduces the potential for mis-selling.

24. Neutral Grid

Compensation grids are neutral when payout rates and revenue tiers do not differ by product or service sold to the client or by account or client type. Simpler compensation grids tend to discourage representatives from focusing on any one product or service for personal gain.

25. Penalties for poor sales practices

The firm has policies in place that clearly define penalties for poor sales practices (e.g., tracking client complaints), including a credible mechanism for recouping previously paid compensation. This practice encourages representatives to focus on the quality, as well as quantity, of sales.

26. Client Turnover

Compensation is tied in some way to client turnover or the average length of client relationships in representatives' books of business. This incentive practice encourages representatives to focus on creating long-term, high value client relationships.

27. Return on book oversight or alarms

The firm actively monitors representatives' return on book or other profitability metrics and investigates representatives with unusually high returns. In addition to helping to limit mis-selling, this practice also helps limit price gouging.

Next Steps

We will continue to analyze the information gathered from the focused activity of the CSA, MFDA and IIROC, as well as the comments received on the Consultation Paper, to determine the appropriate regulatory response, if any, to address conflicts of interest that arise from compensation arrangements and incentive practices.

Questions

Please refer your questions to any of the following:

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