

# **MUTUAL FUND DEALERS ASSOCIATION OF CANADA**

## **PROPOSED AMENDMENTS TO MFDA RULE 2.4.1**

### **(PAYMENT OF COMMISSIONS TO UNREGISTERED CORPORATION)**

#### **I. OVERVIEW**

##### **A. Current Rule**

Rule 2.4.1 currently requires that any remuneration in respect of business conducted by an Approved Person on behalf of a Member be paid by the Member (or an affiliate) directly to and in the name of the Approved Person.

##### **B. The Issues**

In response to industry concerns with respect to Rule 2.4.1, the securities regulatory authorities in British Columbia, Saskatchewan, Ontario and Nova Scotia (the “Applicable Jurisdictions”) suspended the operation of the Rule as a term and condition of the MFDA’s recognition provided certain conditions were met. The period of suspension, originally set to expire on December 31, 2004, was subsequently extended to December 31, 2008.

On July 17, 2008, the MFDA submitted an application to the Applicable Jurisdictions to amend the Recognition Orders of the MFDA as a Self-Regulatory Organization (“SRO”) in those jurisdictions to extend the suspension of Rule 2.4.1 until December 31, 2010. The MFDA requested this extension to allow it time to develop proposed amendments to Rule 2.4.1 which will permit Approved Persons to direct remuneration in respect of business conducted by them on behalf of a Member to an unregistered corporation, subject to conditions. On August 29, 2008, the Applicable Jurisdictions published the MFDA’s application and related documents for a public comment period expiring on September 29, 2008.

Commenters emphasized the need for an appropriate solution to be developed within the timelines established by the Applicable Jurisdictions or for the suspension of Rule 2.4.1 to be extended until such time as a permanent solution is reached. In addition, while acknowledging that a directed commissions approach would be workable, commenters expressed the need for a solution that is harmonized across the industry and all jurisdictions, indicating their preference for the adoption of legislative amendments allowing for an incorporated salesperson model.

On December 19, 2008, the Applicable Jurisdictions issued a Joint Notice of Approval of the Amendments to the MFDA Recognition Order (“Joint Notice”) extending the current suspension of Rule 2.4.1 until March 31, 2010, with a requirement for the MFDA to submit

its proposed amendments to Rule 2.4.1 by May 31, 2009.

### **C. Objectives**

The objective of the proposed amendments is to allow an appropriate degree of flexibility in how Members and their Approved Persons structure their business affairs in respect of the payment of remuneration for business conducted by an Approved Person on behalf of their Member. The proposed amendments also ensure investor protection by preserving the liability of Members and their Approved Persons to clients for the actions of Approved Persons.

### **D. Effect of Proposed Amendments**

The proposed amendments will allow Members and their Approved Persons an appropriate degree of flexibility in how they structure their business affairs by permitting remuneration to be directed to unregistered corporations, provided that certain conditions are satisfied. These conditions address investor protection concerns that might arise in connection with Approved Persons directing commissions to unregistered corporations.

## **II. DETAILED ANALYSIS**

### **A. Relevant History**

In 1999, the Canadian Securities Administrators (“CSA”) Distribution Structures Committee published a position paper (the “CSA Position Paper”) that outlined their regulatory concerns with existing structures and practices that had evolved in the industry. One of the topics addressed in the CSA Position Paper was related to concerns with the industry practice of dealers paying commissions to non-registered corporations.

The recognizing CSA Members advised the MFDA that MFDA Rules must conform to the positions articulated in the CSA Position Paper. As a result, the MFDA developed Rule 2.4.1 that was included in the MFDA's application for recognition as an SRO and submitted to the securities commissions on December 22, 1999. The MFDA's application was published for a 90-day comment period in June 2000.

In response to industry concerns with respect to Rule 2.4.1, the Applicable Jurisdictions suspended the operation of the Rule provided that certain conditions set out in Member Regulation Notice MR-0002 – *Payment of Commissions to Non-Registered Entities* (“MR-0002”) were met. The suspension of the Rule was referenced in the Terms and Conditions of Recognition of the MFDA issued by some of the Applicable Jurisdictions. The period of the suspension, originally set to expire in 2004, was subsequently extended by the Applicable Jurisdictions to December 31, 2008.

On May 23, 2008, the New Brunswick Securities Commission made a Variation Order to the terms and conditions of MFDA Recognition as an SRO in New Brunswick to suspend Rule

2.4.1 until such time as a decision or legislative amendments have been made with respect to the payment of commissions to unregistered entities. On September 12, 2008, the Manitoba Securities Commission issued a similar Variation Order indefinitely suspending Rule 2.4.1.

As a result, provided the conditions set out in MR-0002 are satisfied, Members with Approved Persons registered in British Columbia, Manitoba, New Brunswick, Nova Scotia, Ontario and Saskatchewan are permitted to pay remuneration on behalf of those Approved Persons to a corporation that is itself not registered as a dealer or a salesperson.

The Alberta Securities Commission has not suspended Rule 2.4.1 and, accordingly, in Alberta commissions must be paid directly to the registered salesperson.

#### Effect of Suspension of Rule 2.4.1

Over the course of the suspension period for the Rule, the MFDA has had the opportunity to review the effect of the suspension on the application of other MFDA Rules and its potential effect on other investor protection issues. MFDA staff estimates that, of the approximately 75,000 registered MFDA Approved Persons, approximately 35,000 are Approved Persons of bank-owned Members who do not rely on the suspension of the Rule and that a high proportion of the approximately 40,000 remaining Approved Persons are likely to rely on its suspension. Despite these large numbers and the fact that the suspension has been in place for several years, the MFDA has not identified any regulatory concerns, including the liability of Approved Persons arising from the payment of commissions to corporations. In this regard, the protections expected for investors under current legislation are maintained.

MFDA Rule 1.1.1 provides that, in general, no Member or Approved Person may, directly or indirectly, engage in any securities related business unless it is carried on for the account of the Member, through its facilities and in accordance with the By-laws and Rules. Each Approved Person who conducts or participates in any securities related business in respect of a Member must comply with the By-laws and Rules as they relate to the Member or such Approved Person.

MFDA Rules 1.1.4 and 1.1.5 set out the required terms for the Member/Approved Person employment or agency relationships permitted under MFDA Rules, including the Member's obligation to supervise the activity of the Approved Person and the Approved Person's responsibility to comply with MFDA requirements and conduct business through the Member. MFDA Rule 1.2.1(d) sets out a number of limitations on non-securities related business that Approved Persons may conduct outside the Member and disclosure requirements where Approved Persons engage in such activity. MR-0002 sets out the conditions for reliance on relief from Rule 2.4.1. The sample form agreement contained in Schedule "A" to MR-0002 must be executed by any Approved Person that seeks to rely on the relief from Rule 2.4.1. This agreement provides for access by regulators, the MFDA and the Member to books and records of the corporation to which commissions have been directed and requires the corporation to cooperate in the event of any review for compliance with regulatory requirements.

The Rules noted above have been implemented to ensure that all securities related business conducted by Members and Approved Persons is conducted through the Member firm and in accordance with MFDA By-laws and Rules. The MFDA is of the view that the requirements and regulatory oversight built into Rule 1 address any concerns that might arise in connection with registrants somehow escaping regulatory liability by directing commissions to unregistered corporations. The MFDA is satisfied that the existing provisions properly address the issue and notes that there are no cases where clients have been at risk based on the entity to which commissions are paid.

### Tax Issues

The MFDA does not monitor Member or Approved Person compliance with tax legislation and this position is consistent for both Approved Persons who receive their commissions directly and those who have commissions directed to corporations. Compliance with tax legislation is subject to review by the relevant taxing authorities and the MFDA does not have the expertise to properly monitor and assess it. Such compliance depends on the particular facts and circumstances of the taxpayers and general statements and positions as to the application of tax legislation are not helpful or reliable. The foregoing position does not mean that the MFDA would not be concerned if its Members or their Approved Persons were not complying with the relevant tax legislation (as would be the case with any legislation), particularly if non-compliance resulted in financial pressures or liabilities to Members or Approved Persons.

### **B. Proposed Amendments**

The proposed amendments to Rule 2.4.1 will permit Members to pay remuneration in respect of business conducted by an Approved Person on behalf of a Member to a corporation that is itself not registered as a dealer or salesperson, provided that:

- such arrangements are not prohibited or otherwise limited by the relevant securities legislation or securities regulatory authorities;
- the corporation is incorporated under the laws of Canada or a province or territory of Canada; and
- the Member, Approved Person and the unregistered corporation have entered into an Agreement in writing, in a form prescribed by the Corporation, in favour of the Corporation, providing that: (i) the Member and Approved Person shall comply with applicable MFDA By-Laws and Rules and remain liable to third parties, including clients, irrespective of whether any remuneration, gratuity, benefit or any other consideration is paid to an unregistered corporation and no such payment shall, in and of itself, in any way limit or affect the duties, obligations or liability of the Member or Approved Person under MFDA Rules; (ii) the Member shall engage in appropriate supervision with respect to the conduct of the Approved Person and its unregistered corporation to ensure compliance as referred to in (i), above; and (iii) the Approved Person and the Approved Person's unregistered corporation shall

provide the Member, the applicable securities commission and the MFDA with access to all books and records maintained by or on behalf of either of them for the purpose of determining compliance with MFDA Rules and applicable securities legislation.

### **C. Issues and Alternatives Considered**

#### IIROC Proposal

Since Rule 2.4.1 was first published for comment in June 2000, stakeholders have recommended and the MFDA has considered a number of solutions, including a proposed incorporated salespersons model put forward by the Investment Industry Regulatory Organization of Canada (“IIROC”), formerly the Investment Dealers Association of Canada (“IDA”).

IIROC members are permitted to use either an employer/employee or a principal/agent structure to deal with their salespersons. A third structure was proposed by IIROC requiring amendments to what was then IDA By-law 39 that would allow members to enter into an agency relationship with an incorporated agent. This new structure would have required an agreement between the member, the incorporated agent and its Approved Person and operate in a similar fashion to the principal/agent structure currently in place. We understand the CSA advised IIROC that it had considered but did not support the proposal. The CSA did, however, invite IIROC to consider other models, including the directed commissions approach reflected in the proposed MFDA amendments.

In the Joint Notice of December 19, 2008, the CSA noted its concern with any proposal in which unregistered corporations perform registerable activities and the need for the development of a solution that does not diminish investor protection. We note that the MFDA’s approach is aimed only at allowing remuneration to be directed to unregistered corporations and not the creation of a regime that would permit such entities to engage in activities requiring registration, as was proposed in the IIROC model.

#### Introducing/Carrying Dealer Model

Another alternative considered was the adoption of an introducing/carrying dealer model with the registration of incorporated salespersons as MFDA Level 1 introducing dealers. A Level 1 introducing dealer cannot operate independently and requires sponsorship by a carrying dealer that is jointly and severally liable for all of the activities of the introducing dealer. This proposal would require, through the joint and several liability of the sponsoring dealer, direct oversight of the activities of incorporated salespersons. The MFDA, to date, does not have any dealers under this category of registration.

This proposed solution was determined to be impractical as it raised a number of significant problems. Under this model, carrying dealers would have to assume joint and several liability for all activities conducted by a salesperson’s corporation (i.e. securities and non-

securities related business). Salespersons would thus have to incorporate an additional entity whose activities would be restricted to engaging in securities related business. This arrangement would increase the likelihood of client confusion as there would be multiple entities whose existence and role the client would have to be kept apprised of on an ongoing basis: (i) the carrying dealer of the introducing dealer (salesperson's corporation) that has joint and several liability with respect to the activities of the introducing dealer; (ii) the salesperson's corporation that only engages in securities-related business (for which the carrying dealer would assume joint and several liability); and (iii) the salesperson's corporation that engages in non-securities related business (for which the carrying dealer would not assume any liability).

Other problems include costs associated with becoming a Level 1 introducing dealer (e.g. costs of having to submit to the same level of oversight as Level 2-4 dealers, including requirements in respect of financial filings, minimum regulatory capital, etc). The costs of regulating such corporate Member salespersons would be borne by them and would likely outweigh any potential tax savings.

#### **D. Comparison with Similar Provisions**

We note that IIROC rules do not currently permit the payment of commissions to unregistered corporations.

Throughout Canada, incorporation of individuals is currently allowed in other industries and professions. For example, insurance licensed advisors, lawyers, accountants and doctors are permitted to operate under an incorporated structure. The MFDA is of the view that the adoption of such a structure is not necessary to allow for the payment of remuneration to non-registered corporations and, as noted above, believes that the proposed amendments are effective and appropriate in scope.

#### **E. Systems Impact of Amendments**

It is not anticipated that there will be a significant systems impact on Members as a result of the proposed amendments.

#### **F. Best Interests of the Capital Markets**

The Board has determined that the proposed amendments are consistent with the best interests of the capital markets.

#### **G. Public Interest Objective**

The proposed amendments have been developed having regard to the MFDA's primary mandate of protecting investors. The proposed amendments will allow Members and their Approved Persons an appropriate degree of flexibility in how they structure their business affairs while not diminishing investor protection.

### III. COMMENTARY

#### A. Filing in Other Jurisdictions

The proposed amendments will be filed for approval with the Alberta, British Columbia, Manitoba, New Brunswick, Nova Scotia and Ontario Securities Commissions and the Saskatchewan Financial Services Commission.

#### B. Effectiveness

The proposed amendments are simple and effective.

#### C. Process

The proposed amendments have been prepared in consultation with relevant departments within the MFDA. The MFDA Board of Directors approved the proposed amendments on June 4, 2009.

#### D. Effective Date

The proposed amendments will be effective on a date to be subsequently determined by the MFDA.

### IV. SOURCES

MFDA Rule 2.4.1

### V. REQUIREMENT TO PUBLISH FOR COMMENT

The MFDA is required to publish for comment the proposed amendments so that the issues referred to above may be considered by the Recognizing Regulators.

**The MFDA has determined that the entry into force of the proposed amendments would be in the public interest and is not detrimental to the capital markets. Comments are sought on the proposed amendments.** Comments should be made in writing. One copy of each comment letter should be delivered by September 17, 2009 (within 90 days of the publication of this notice), addressed to the attention of the Corporate Secretary, Mutual Fund Dealers Association of Canada, 121 King St. West, Suite 1000, Toronto, Ontario, M5H 3T9 and one copy addressed to the attention of Sarah Corrigan-Brown, Senior Legal Counsel, British Columbia Securities Commission, 701 West Georgia Street, P.O. Box 10142, Pacific Centre, Vancouver, British Columbia, V7Y 1L2.

Those submitting comment letters should be aware that a copy of their comment letter will be made publicly available on the MFDA website at [www.mfda.ca](http://www.mfda.ca).

Questions may be referred to:

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Docs # 167983v3



## SCHEDULE A

### MUTUAL FUND DEALERS ASSOCIATION OF CANADA

#### PAYMENT OF COMMISSIONS TO UNREGISTERED CORPORATION

##### (Rule 2.4.1)

On June 4, 2009, the Board of Directors of the Mutual Fund Dealers Association of Canada made the following amendments to Rule 2.4.1:

#### 2.4 REMUNERATION, COMMISSIONS AND FEES

2.4.1 (a) **Payable by Member Only.** Any remuneration in respect of business conducted by an Approved Person on behalf of a Member must be paid by the Member (or its affiliates or its related Members which have received it from the Member) directly to and in the name of the Approved Person.

No Approved Person in respect of a Member shall accept or permit any associate to accept directly or indirectly, any remuneration, gratuity, benefit or any other consideration from any person other than the Member or its affiliates or its related Members, in respect of the business carried out by such Approved Person on behalf of the Member or its affiliates or its related Members.

(b) **Payment of Commissions to Unregistered Corporation.** For the purpose of this Rule, “unregistered corporation” shall be understood to mean a corporation that is, itself, not registered as a dealer or salesperson. Notwithstanding paragraph (a), any remuneration, gratuity, benefit or other consideration in respect of business conducted by an Approved Person on behalf of a Member may be paid by the Member to an unregistered corporation provided that:

(i) such arrangements are not prohibited or otherwise limited by the relevant securities legislation or securities regulatory authorities;

(ii) the corporation is incorporated under the laws of Canada or a province or territory of Canada;

(iii) the Member, Approved Person and the unregistered corporation have entered into an Agreement in writing, in a form prescribed by the Corporation, in favour of the Corporation, the terms of which provide that:

(A) the Member and Approved Person shall comply with applicable MFDA By-laws and Rules and remain liable to third parties,

including clients, irrespective of whether any remuneration, gratuity, benefit or any other consideration is paid to an unregistered corporation and no such payment shall, in and of itself, in any way limit or affect the duties, obligations or liability of the Member or Approved Person under MFDA Rules;

(B) the Member shall engage in appropriate supervision with respect to the conduct of the Approved Person and its unregistered corporation to ensure such compliance as referred to in (A), above; and

(C) the Approved Person and the Approved Person's unregistered corporation shall provide the Member, the applicable securities commission and the MFDA with access to all books and records maintained by or on behalf of either of them for the purpose of determining compliance with MFDA Rules and applicable securities legislation.