IIACACCVM
INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

LETTER FROM THE PRESIDENT

Vol. 108

IIROC Rule 42 Compensation-Related Conflicts Review: Observations and Next Steps

HIGHLIGHTS:

The IIROC review indicates firms need to improve the quality of disclosure of compensated-related conflicts. The review also infers that more detailed practical guidelines would be helpful for firms to address compensation conflicts in certain situations.

Fee-based and managed accounts have become increasingly popular and have proliferated in the industry as these accounts offer a widening array of services, extending beyond advice and securities execution to include financial planning and fund transfers, and to specialized tax advice and tax-reporting. The conflicts between fees paid on fee-based and transaction accounts are best addressed through disclosure of the account details and suitability of the account for the client.

IIROC should examine Rule 42 in conjunction with other IIROC rules that relate to business conflicts to identify where rules and guidelines might be streamlined.

The traditional advisory and brokerage business is replete with extensive conflicts of interest, notably the conflicts between buyers and sellers, from proprietary dealings though dealers in over-the-counter debt securities, new securities offerings, and the fees and charges to clients for services. These inherent conflicts have been the driving force behind the reforms for greater transparency in client dealings and for a higher standard of obligations for advisors.

In 2012, IIROC implemented Rule 42, a principles-based rule requiring firms to identify and manage conflicts of interest in the business. While Rule 42 is a general or broad-based rule to address conflicts, it was deemed necessary because the existing IIROC rulebook did not deal specifically with compensation-related conflicts, considered the heart of the conflict challenge for the securities industry.

IIROC has recognized many rules in the rulebook require firms to address conflicts in the context of specific business situations. IIROC has enumerated several key examples such as Rule 3300.3 related to fair pricing of OTC securities, Rule 1402 requiring dealers to observe high standards of conduct, Rule 38.1 requiring dealers to establish and maintain a proper system of supervision and Rule 1300.15 regarding conflicts in relation to allocation of securities among clients in managed accounts. Further, dealers have an overriding obligation that advisors have a duty of care and act honestly, fairly and in good faith with the client. Finally, suitability rules impinge on compensation-related conflicts in decisions related to fee-based or managed accounts versus transaction accounts.

After several iterations, IIROC finally approved the Conflicts of Interest, Rule 42. The final version of the rule required that conflicts be addressed, not just in a fair, equitable and transparent manner, but consistent with the best interests of the client.

A LOOK BACK AT RULE 42

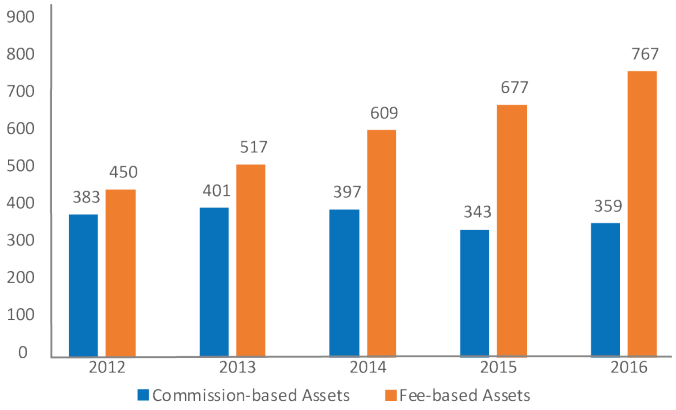
Three years after implementing the new rule, IIROC undertook a broad examination of compliance with Rule 42 among a cross-section of firms. This was followed by comprehensive survey of firms in June 2016 to review compensation-related conflicts. These reviews were a far-sighted step taken by the regulator, essentially a learning exercise for both the regulator and IIROC-registered firms, providing information to assess the effectiveness of the new rule. By undertaking this comprehensive "look back" at the Rule 42, IIROC has set a good example for other regulators through this detailed and interactive rule-making effort, a process still underway.

The compliance exercise is particularly important because Rule 42 has two unique features: First, conflicts are now dealt with through a broad principles-based rule, as well as through various other specific IIROC rules such as know-your-client, suitability, general conduct and supervision, etc. Second, the final version of Rule 42 added the obligation to manage conflicts consistent with the best interests of the client, leaving firms to figure out the compliance obligation over and above managing conflicts in a fair, equitable and transparent manner.

In view of the importance of the recent findings to the regulatory process, IIROC is encouraged to expand its objectives of the post-examination review beyond compliance with Rule 42 and consider broader regulatory questions: Has the principle-based Rule 42 improved the management of compensation-based conflicts? Has Rule 42 been necessary, or would

modification to the existing IIROC rules related to conflicts, or more detailed guidelines on specifics compensation conflicts, been more effective? Is there duplication of compliance requirements in managing conflicts? Are there unnecessary complications or excessive costs for firms complying with Rule 42? Are additional guidelines on compliance with Rule 42 necessary?

Full-Service Brokerage Asset Mix ($B)

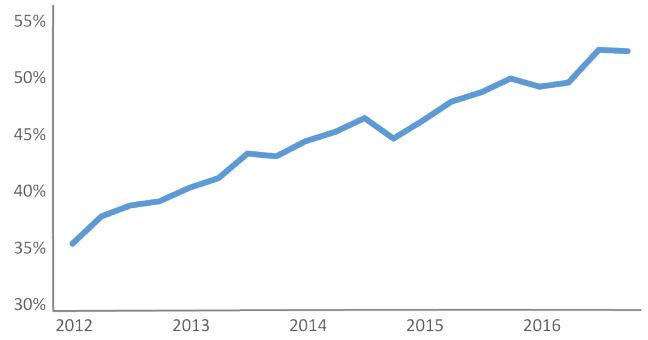


Data Source: Strategic Insights, Retail Brokerage and Distribution Reports

IDENTIFIED COMPLIANCE PROBLEMS

The review uncovered four problems: inadequate disclosure of compensation-based conflicts of interest; reliance on disclosure without firms first addressing the specific conflict; lack of firm "review" or focus on the conflict problems related to compensation; and the lack of proper monitoring and supervision of the unique risks in fee-based and managed accounts related to fee or compensation conflicts.

Fees as Percentage of Industry Retail Revenues



Data Source: IIAC, IIROC Monthly Financial Reports

First, the extensive reliance on disclosure to deal with compensation-related conflicts shouldn't be surprising given the complexities of the conflicts at issue and various mechanisms available to address and mitigate them. This mitigation of conflicts may have been a problem for firms given the lack of sufficient industry guidance for dealing with specific conflicts. For example, the review refers to differences in advisor payouts between third-party fund products and in-house funds. These relative payouts are explained as cost differences. Beyond disclosing the payout differences, how should the third party and in-house funds be treated in terms of adjusting payouts and client charges? What about concerns regarding the independence of supervisors? Should supervisors be entitled to a portion of advisor revenues even if fully disclosed, and what should the portion be? Finally, these compensation conflicts must be addressed in the "best interests of the client", requiring firms to interpret the meaning of best interest. What should firms be doing to address specific cases of compensation-related conflicts, beyond precedents already in place, to meet the best interests of the client?

FEE-BASED ACCOUNTS

The lack of specific measures under Rule 42 to address compensation may also reflect the fact firms are employing approaches to manage conflicts under policies and procedures related to other IIROC rules. For example, the IIROC compliance survey suggests firms need to do a better job addressing compensation conflicts between fee-based and transaction accounts. The regulatory focus here is on transaction activity in fee-based and managed accounts, and corresponding appropriateness of the account fee. However, the conflict related to relative fee charges may have been addressed, not through specific policies related to the principles-based conflicts rule, but through Know-Your-Client and suitability obligations, and appropriateness of the fee-based or managed account for the client.

The regulator needs a good understanding of fee-based accounts and their evolution to assess the compensation conflicts and how they are managed by firms. As the IIROC review notes, fee-based accounts are popular and have proliferated widely through the industry. Clients demand much more than securities execution and investment advice in these accounts. Many of these fee-based accounts offer financial planning, tax-reporting, and execution and clearing costs related to account transactions as funds are frequently switched into and out of managed accounts. The fees typically range from 50 basis points to 150 basis points, with higher fees skewed to the smaller accounts. Interestingly, these fees are under downward competitive pressure, in much the same way as the earlier squeeze in brokerage commissions.

The account thresholds in fee-based accounts have been moving up steadily to the $250,000 range to justify rapidly rising fixed costs, resulting in the jettisoning small account for the investment dealer, partly the side-effect of escalating regulatory costs.

The compensation or fee conflict related to fee-based and managed accounts—the value proposition for the account fee—must take into consideration the many features of the account, not just securities transactions. Further, it should be recognized that the perceived conflict of less transactional volume may relate to an advised "buy and hold" strategy that intentionally limits portfolio adjustments, given prevailing market conditions.

Proper disclosure of the detailed services provided in fee-based accounts, and documentation of the suitability decision related to the account, represent the appropriate compliance response. The suitability recommendation is made in conjunction with the obligation to deal honestly, fairly and in good faith with the client.

Indeed, most firms monitor fee-based accounts internally in terms of transactional and fund transfer activity, and other indicators, to ensure account fees are properly linked to account services. These internal practices are likely integral to the IIROC review of fee-based account conflicts. The worry, however, is that excessive focus on transaction volume in individual fee-based accounts could lead to costly "fishing expeditions", and result in needless and inefficient compliance reviews.

CONCLUSION

IIROC has approached its rule-making responsibilities in respect of Rule 42 in a careful and responsible manner. The regulator has taken a vigorous "look back" at the Rule to assess the need for amendment and further industry guidance, particularly as the Rule focuses on compensation-based conflicts, such as rapidly growing and increasingly complex fee-based and managed accounts, and introduces the concept of client best interest. The industry views this review as a positive initial step, anticipating more detailed guidance on compensation-based conflicts and an assessment of the overall effectiveness of Rule 42, particularly in conjunction with other IIROC rules and guidance dealing with conflicts of interest.

Yours sincerely,

Ian C. W. Russell, FCSI
President & CEO, IIAC
June 2017