

13.1.2 Amendments to MFDA Rule 2.4.1 – Payment of Commissions to Unregistered Corporation

MUTUAL FUND DEALERS ASSOCIATION OF CANADA

PAYMENT OF COMMISSIONS TO UNREGISTERED CORPORATIONS
MFDA RULE 2.4.1

(Blacklined To Version Published For Comment at (2009) 32 OSCB 5149)

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 under securities legislation. Notwithstanding paragraph (a), where an Approved Person acts as an agent of the Member in compliance with MFDA Rule 1.1.5, any remuneration, gratuity, benefit or other consideration in respect of business conducted by ~~an~~the 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 securities legislation 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 and applicable securities legislation;

(B) the Member shall engage in appropriate supervision with respect to the conduct of the Approved Person and ~~its~~the 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.

- (c) Arrangements Prohibited. Paragraph (b) does not apply in respect of any such remuneration, gratuity, benefit or other consideration derived from a client in Alberta.

Summary of Public Comments Respecting Proposed Amendments to MFDA Rule 2.4.1

Summary of Public Comments Respecting Proposed Amendments to MFDA Rule 2.4.1 (Payment of Commissions to Unregistered Corporation) and Responses of the MFDA

On June 19, 2009, the British Columbia Securities Commission and Ontario Securities Commission published proposed amendments to MFDA Rule 2.4.1 (Payment of Commissions to Unregistered Corporation) (the “**Proposed Amendments**”) for a 90-day public comment period.

The public comment period expired on September 17, 2009.

6 submissions were received during the public comment period:

1. Advocis
2. dcp Financial Management Ltd. (“dcp”)
3. Independent Financial Brokers of Canada (“IFB”)
4. Investment Industry Association of Canada (“IIAC”)
5. Kelly Strem
6. McInnes Cooper

Copies of comment submissions may be viewed at the offices of the MFDA, 121 King Street West, Suite 1000, Toronto, Ontario by contacting Ken Woodard, Director, Communications and Membership Services, (416) 943-4602.

The following is a summary of the comments received, together with the MFDA's responses.

Support for MFDA Directed Commission Model

The IFB commended the MFDA for proposing a harmonized approach that will apply equally to all mutual fund registrants and noted that the extended suspension of Rule 2.4.1 in many jurisdictions in past years has indicated that directing commissions to an unregistered corporation poses no regulatory risks.

MFDA Response

Staff acknowledges the comment.

Support for Incorporated Salesperson Model

Advocis expressed support for the Proposed Amendments but recommended that the MFDA present them to the Canadian Securities Administrators (“CSA”) as part one of a two-part process to provide a comprehensive solution to the incorporation issue. Advocis acknowledged that the Proposed Amendments exhaust the full scope of the MFDA's regulatory authority, and recommended that part two of the process should be a clear expression from the MFDA for the CSA to commence a process to make the necessary legislative changes to provincial securities acts to allow for incorporated salespersons. Advocis recognized that part two of the process is beyond the scope of MFDA regulatory authority; however, it suggested that it is within MFDA authority to indicate what actions are needed and to provide suggested solutions to the CSA.

Advocis acknowledged that, in preparing the Proposed Amendments, the MFDA was limited by time constraints, as the Applicable Jurisdictions indicated that they will not extend the current suspension of Rule 2.4.1 beyond March 31, 2010; however, it recommended that the MFDA take a comprehensive approach to resolving the incorporation issue.

Advocis recommended that the MFDA promote to the CSA the need to amend the definition sections of the applicable *Securities Acts* to explicitly state that an ‘adviser’, ‘salesperson’, or ‘person’ captures the concept of a corporation and noted that a commitment from the commissions to issue Blanket Orders exempting corporations from the registration requirements under the applicable securities acts would provide added clarity. Advocis proposed that future provisions regarding the definition of salesperson strip away the corporate veil but only against liability for market conduct related to the registered activity in the sale and distribution of securities and suggested a number of provisions that could be included in future legislation to achieve this goal. Advocis also suggested requiring that a salesperson, his or her corporation and the dealer enter into a contract with prescribed terms that would offer additional assurances that registrant salespersons will not seek shelter from their obligations behind the corporate veil.

Advocis noted the existence of Prince Edward Island *Securities Act* that allows for the incorporation of licensed salespersons and remarked that the Prince Edward Island Securities Office also issued Blanket Order 33-504 exempting a corporation from having to register. Advocis also noted that proposed 2003 British Columbia *Securities Act* and 2008 draft *Securities Act* (Canada) which, if adopted and proclaimed, would provide the legislative solution to the issue, as well as legislation adopted by

various provinces that permits some professions to incorporate while preserving the accountability of the individual, such as those found under some *Business Corporations Acts*.

Noting tax concerns, McInnes Cooper and the IIAC recommended a legislative amendment to allow corporations to carry on registrable activities. McInnes Cooper noted a pattern established for a number of professions through provincial legislation by allowing, subject to appropriate restrictions to protect the public, members of those professions to practice through corporations that are licensed to do so.

MFDA Response

Staff acknowledges the industry's preference for amendments to the various Securities Acts that would allow for incorporated salespersons and has communicated this information to the CSA.

Harmonization across Jurisdictions

Advocis expressed the view that the objective of a harmonized approach between Recognizing Jurisdictions, while laudable, should not become a hurdle to the best possible solution and recommended that, if full harmonization cannot be achieved, all willing Recognizing Jurisdictions ("Applicable Jurisdictions") move forward with the Proposed Amendments supported by the majority, allowing reluctant jurisdictions to opt out or issue a Local Order suspending the practice in their jurisdiction.

Advocis expressed the view that the wording of proposed subsection 2.4.1(b)(i), which states that payment of commissions to an unregistered corporation be allowed provided "such arrangements are not prohibited or otherwise limited by the relevant securities legislation or securities regulatory authority", weakens the purpose underlying the Proposed Amendments and is an unnecessary compromise clause included to ensure that securities regulatory authorities in jurisdictions other than Applicable Jurisdictions, such as Alberta Securities Commission ("ASC"), which has clearly stated its opposition, can support the MFDA proposal. Advocis expressed the opinion that the overall effect of this approach weakens the perceived commitment on the part of the MFDA and the Applicable Jurisdictions to achieving the best solution and recommended that the MFDA remove this subsection.

Advocis recommended that, instead of including the qualification in subsection 2.4.1(b)(i), if a particular jurisdiction wishes to prohibit the right to incorporate, it issue a Local Order stating that MFDA Rule 2.4.1(b) will not apply in their jurisdiction. Advocis noted that removing subsection 2.4.1(b)(i) would not alter the incorporation status of advisors in Alberta as the ASC has clearly stated it will not support this initiative at this time. Accordingly, removal of this subsection would more clearly reflect the will of the majority of the Recognizing Jurisdictions, and clearly reflect the position of the ASC.

Advocis recommended that the MFDA and the Applicable Jurisdictions approach the Proposed Amendments with the foresight that the concerns preventing the ASC from extending the right to incorporate to licensed salespersons in that province will eventually be addressed. Advocis suggested that the ASC, in issuing an Order disallowing MFDA Rule 2.4.1(b), would attach to it a termination date, at which point the ASC could extend the Order, or if their concerns have been addressed, allow the Order to expire, thus bringing it in line with the Applicable Jurisdictions and extending the benefits associated with incorporation to advisors in that province.

Dcp, which operates through a corporation in Alberta, expressed the view that the fact that the ASC does not allow to direct commissions to unregistered corporations adds complication and cost to the management of business and provides no identified additional protection for the consumer. Dcp and Kelly Strem, a financial planner and Approved Person based in Alberta, advocated extending the directed commission model to Alberta, noting that this would allow for improvement of overall business efficiency, a much more streamlined management of revenues and expenses, as well as for business planning strategies with no detriment to investor protection and would remove other inefficiencies in the current business structures.

MFDA Response

MFDA staff is fully supportive of a harmonized approach amongst the Recognizing Jurisdictions. However, the current positions of the Recognizing Jurisdictions are not uniform and MFDA Rules need to accommodate any inconsistencies. For compliance and enforcement reasons, it is more transparent and clear to Members to outline Member requirements in an MFDA Rule.

Extend Permission to Use Corporation to All Financial Advisors

The IIAC recommended that, to promote a level playing field in the Canadian financial services industry, there be consistency between MFDA Rules and those of the Investment Industry Regulatory Organization of Canada ("IIROC") and noted the current inconsistency with respect to payment of commissions to personal corporations and the fact that the Proposed Amendments will codify this inconsistency. The IIAC recommended a legislative amendment that would allow both MFDA and IIROC Approved Persons to conduct registrable activities through a corporation, as this is the only approach that would provide the same business and tax benefits to advisors as are available to other professionals. The IIAC recalled a proposed IIROC rule, which

was approved by IIROC (then the Investment Dealers Association of Canada) Board of Directors and presented to the CSA for approval in January 2006, noting, however, that the CSA was not prepared to approve the rule as it felt investor protection would be compromised.

The IIAC expressed the view that such a legislative amendment is integral to the cost-effective delivery of financial services, the facilitation of fair and open competition in the overall wealth management business and the standardization of industry structures while ensuring that appropriate tax and other benefits are achieved in compliance with all applicable legislation including securities and tax.

In the event the incorporation approach is not adopted, the IIAC recommended extending the effect of the Proposed Amendments to IIROC salespersons who wish to conduct their business through a corporation.

The IIAC recommended that a committee be established, comprised of representatives from the MFDA, IIROC, the IIAC and the CSA to develop a permanent, workable solution that would provide an appropriate regulatory, corporate and tax structure and would also create a level playing field for IIROC and MFDA advisors who wish to incorporate. The IIAC expressed the view that such a solution would provide advisors with all the advantages associated with a true corporate structure while ensuring that investors are fully protected.

MFDA Response

Staff acknowledges the desirability of arriving at a solution that is harmonized across jurisdictions and that creates a level playing field among all financial advisors. Staff continues to be willing to work with other regulators and industry stakeholders to accomplish this objective.

Tax Issues

The IIAC noted that, under the *Income Tax Act*, the Canada Revenue Agency may recognize a corporation as carrying on a professional practice unless provincial law or the regulatory body for the particular profession provides that only individuals may practice the profession, in which case income derived from the profession will normally be considered to be earned by the individual who rendered such professional services and not by the corporation. The IIAC remarked that, at this time, securities legislation across Canada provides that only individuals may engage in registrable activities and that, for a corporation to earn income, it must in fact be performing services, as otherwise income will be taxed as income of the individual and not of the corporation, thus suggesting that the Proposed Amendments will not have the desired tax consequences.

McInnes Cooper expressed the view that, since an unregistered corporation is not authorized to carry on a securities-related business, any income earned from such a business through the efforts of an Approved Person would not be beneficially earned by the corporation. McInnes Cooper expressed the view that it would be hazardous, from a tax point of view, for an Approved Person, relying on Rule 2.4.1 if the Proposed Amendments come in effect, to direct qualifying income to an unregistered corporation on the assumption that the corporation, and not the Approved Person, would be taxable on that income. McInnes Cooper expressed the view that, if a tax benefit cannot be obtained, it is hard to see what advantage there would be in such an arrangement as such an individual could transfer after-tax income to a corporation at any time, without the need for permission from the MFDA.

The IFB and dcp acknowledged the concerns identified in the letter submitted by McInnes Cooper. The IFB agreed that all Approved Persons considering directed commission model should seek expert advice to ensure they find the most appropriate solution to fit their business needs; however, the IFB noted that tax matters should be dealt with outside of the MFDA or securities legislators.

MFDA Response

While staff understands the tax considerations involved and has received many comments in respect of this issue, the amendments as proposed have not been drafted to achieve a particular tax outcome. As noted, the Proposed Amendments are intended to allow for commissions to be directed to unregistered corporations in a manner that is simple and that does not compromise investor protection. Such arrangements would be expected to be consistent with applicable tax legislation but that is a matter for Members, Approved Persons and taxation authorities to address.