

Consultation Paper

December 20, 2010

**Consultation on Possible Options
for the Incorporation of Individual Representatives
of Registered Dealers and Advisers in Canada**

PURPOSE

A working group of provincial/territorial government officials has been struck to work with industry, provincial/territorial securities regulators, self-regulatory organizations and other stakeholders to explore options for the incorporation of individual sales representatives of registered dealers and advisers, and any impact on investor protection.

REQUEST FOR COMMENTS

The intent of this consultation paper is to provide consumers, market participants and other stakeholders with an opportunity to provide their feedback on possible options for the incorporation of individual sales representatives of registered dealers and advisers.

We want your input. Stakeholders are asked to comment on the consultation paper and provide their feedback by **February 25, 2011**.

No government or securities regulator has approved any of these options. They are presented to stimulate public discussion. Your feedback will assist in informing any future policy development.

In order to ensure a transparent consultation process all written comments received during the comment period will be published.

BACKGROUND

Provincial securities regulators, self-regulatory organizations and industry have previously considered the issue of incorporated sales representatives without reaching a resolution.

Industry groups have stressed the need to have a permanent, harmonized solution to ensure a level playing field for all sales representatives of registered dealers and advisers across Canada. A balanced solution would address the business interests of sales representatives of dealers and advisers, protect consumers, and ensure the integrity of Canada's capital markets.

Regulatory Concerns and Framework

Regulatory concerns about payments by dealers and advisers to non-registered corporations were first identified in the 1999 CSA Distribution Structures Committee Position Paper published by provincial/territorial securities regulators.

The 1999 position paper addressed regulatory and accountability issues arising from changes in the manner in which securities firms were structuring their relationship with their sales representatives. These changes were resulting in the commercial provision of securities trading and advising services to the public outside of the traditional employer-employee relationship. Evolving non-traditional business structures included principal-agent relationships, independent contractors, and incorporation without registration.

In considering whether non-traditional structures should be allowed, the CSA committee considered whether those structures were consistent with the following principles:

- the dealer or adviser must be legally responsible for the acts of its sales representatives;
- the dealer or adviser must exercise an appropriate level of supervision over its sales representatives;
- all conflicts of interest must be disclosed to the client and the client must be aware of all of the types of investor protection that are available to the client;
- the dealer must ensure that its sales representatives are and remain competent;
- the dealer and regulators must be able to perform their oversight function; and
- the range of allowable structures must not unduly limit the options available to securities firms.

Applying these principles, the CSA committee concluded that

- a relationship between a dealer and its sales representative that is properly characterized as that of employer and employee is acceptable as long as the liability of a dealer for the acts of its sales representative are governed by a regime of comprehensive statutory liability,
- a principal and agent relationship between a dealer and a sales representative is also acceptable provided that the dealer be responsible for and supervise all of the activities of its sales representatives that relate to the delivery of financial services,
- an arrangement whereby sales representatives would carry out their financial service activities on behalf of a dealer acting as independent contractors would not be acceptable,
- salespersons incorporating in order to conduct registerable trading or advisory activities would not be acceptable.

Payment of Commission:

The positions developed by the CSA committee were intended to apply to all existing and new self-regulatory organizations. The Mutual Fund Dealers Association of Canada (MFDA) and the Investment Dealers Association of Canada (the IDA, now the Investment Industry Regulatory Organization of Canada or IIROC) developed business structure and remuneration rules to conform to the positions articulated in the 1999 position paper, namely requiring commission payments be made to the individual salesperson (and not a corporation).

Operation of the original MFDA remuneration rule (Rule 2.4.1, requiring payments of commissions be made directly to the registrant) was suspended for a three-year interim period to permit the MFDA time to develop amendments to its remuneration rule that would allow sales representatives to direct payment of commissions and other remuneration earned by them to a non-registered corporation.

In March 2010, after the suspension was extended several times, securities regulatory authorities in British Columbia, Saskatchewan, Manitoba, Ontario, New Brunswick and Nova Scotia approved the modification of the MFDA Rule 2.4.1 to permit the redirection of remuneration to a non-registered corporation. This rule change allows registered sales representatives of a MFDA member to have their commissions paid directly to their non-registered corporation, subject to certain conditions.

The modified MFDA Rule 2.4.1 does not permit sales representatives of MFDA members to carry on securities-related activities through incorporated entities. As noted below, this may limit the tax and other benefits to sales representatives. The modified MFDA Rule 2.4.1 does not apply in Alberta as the Alberta Securities Commission continues to work to develop a more comprehensive solution.

IIROC rules currently do not permit the redirection of commissions to non-registered corporations or allow individual sales representatives of IIROC members to incorporate. We note that IIROC (then the IDA) had previously proposed changes to then IDA By-law 39 which would have allowed its members to use incorporated salespersons. The proposed by-law changes were not implemented as the CSA had serious investor protection concerns with them.

Requirement to Register:

Firms in the business of trading in, or advising on, securities must be registered under securities laws. Individual sales representatives who trade or provide advisory services on behalf of a registered dealer or adviser must also be registered. Registered investment dealers and mutual fund dealers (except in Québec) must also be a member of a recognized self-regulatory organization and comply with their bylaws and rules.

Except in Québec, financial advisers and mutual fund dealers are typically members of the MFDA and their sales representatives are employees or agents of a registered MFDA member. Registered securities dealers on the other hand are members of IIROC.

Between 2005 and 2009, provincial securities regulators undertook a comprehensive reform of the registration regime across Canada, culminating in the implementation in September 2009 of a new national registration rule, National Instrument 31-103 *Registration Requirements and Exemptions* (NI 31-103). NI 31-103 requires firms and individuals who are in the business of providing advising and trading services in the Canadian capital markets to register.

The national registration rule does not deal with the incorporation of individual sales representatives of registered dealers and advisers. Therefore, sales representatives of registered dealers and advisers across Canada continue to be prohibited from using a corporation to provide trading and advisory services to clients under provincial/territorial securities laws.

We understand that provincial securities regulators have in principle no objection to permitting individual sales representatives of registered dealers and advisers to incorporate provided regulatory and accountability concerns are met.

Essentially, governments, their regulators and self-regulatory organizations like IIROC and the MFDA want to ensure that:

- the use of a corporation does not impact the flow of liability between the individual sales representative and clients and between the firm and the client,
- individual sales representatives continue to be properly supervised by their registered dealers and advisers,
- regulators oversight of registrants, including continued access to relevant information, is not impeded,
- the costs and benefits to market participants and consumers warrant proceeding with the proposal.

Benefits of Alternative Business Structures

Industry advocates support the use of alternative business structures such as corporations primarily because of the tax and other benefits they may provide. These include

- a more tax-efficient structure to manage business tax flow and disbursements,
- business transfer tax planning flexibility,
- more tax-efficient succession planning, and
- staffing recruitment and retention incentives.

Legislation has been adopted in jurisdictions across Canada to permit certain groups of professionals and other persons required to be licensed to make use of a corporation to provide services. For example, medical, dental, legal and accounting professions, and other occupations are permitted in most jurisdictions, either expressly or through the absence of a prohibition, to make use of a corporation to carry on their business. In the financial services industry, insurance agents are not prohibited from providing services through a corporation in many jurisdictions.

To address concerns that a corporate structure may shield professionals from liability to their clients, special incorporation framework legislation has been developed that explicitly includes safeguards designed to ensure that the

individual professional continues to remain subject to professional liability claims made by his or her clients.

Tax Issues

Some industry associations and individual sales representatives would like the flexibility to provide their services through a corporation. This would allow them to deduct a broader range of business expenses and be subject to more favourable small business tax rates.

Most of the tax advantages associated with incorporation are eliminated if the corporation is categorized as a personal service business for tax purposes (i.e. if the individual taxpayer in substance is an employee rather than an independent contractor). In such cases, full corporate tax rates would apply and any benefit from deferring income tax would be lost. The determination of whether a personal service business exists is made on a case by case basis such that the risk is borne by the individual taxpayer. Whether an individual who provides services to a corporation is acting in his or her capacity as an employee or is an independent contractor is a frequently litigated personal tax issue in Canada. Provincial and federal income tax legislation contains anti-avoidance provisions to prevent individuals who are properly regarded as employees from obtaining tax benefits by incorporating to provide services to what otherwise would be their employer.

Accordingly, it is not clear that there would be tax benefits associated with allowing the incorporation of registered sales representatives or allowing a broader range of registered sales representatives to redirect commissions to their non-registered corporation. To the extent that there are tax deferral benefits in particular cases, those may be restricted to high-income earners who are able to retain significant income in the corporation. Again, the tax treatment would depend on the particular facts and circumstances of the individual taxpayer.

OPTIONS

This paper seeks your views on whether changes are appropriate to the current framework for business structures applicable to individual sales representatives of registered dealers and advisers.

Neither provincial and territorial governments or their securities regulators have approved or endorsed any of the options described below. The working group has presented these options in the interest of stimulating stakeholder discussion.

The working group has identified two legislative incorporation proposals, one developed by the Alberta Securities Commission and the other by Advocis, both of which are designed to permit the incorporation of individual sales representatives of registered dealers and advisers.

A third option would be to level the playing field for mutual fund sales representatives and other securities sales representatives with respect to the payment of their commissions. This would be accomplished by allowing a broader range of sales representatives to redirect their remuneration to a non-registered corporation.

Option 1: Statutory Incorporation Framework:

Alberta Securities Commission Legislative Proposal

In 2008, the Alberta Securities Commission (ASC) developed a proposal that contemplated a legislative framework for incorporation of sales representatives of registered dealers and advisers. The ASC proposal would establish a permit regime for incorporation of sales representatives modeled on the professional corporation permit system used by the legal, accounting, medical and dental professions in Alberta.

Under the ASC proposal, the sales representative's corporation would not have to be registered but would have to obtain an annual permit from the Executive Director authorizing it to provide trading or advising services to clients.

The ASC's proposal imposes shareholder structure restrictions similar to those found in legal, accounting, medical and dental professions legislation. These provisions were recently amended in Alberta (November 2009) to allow non-voting shares of professional corporations to be held by family members (spouse, common-law partner or child of a 'regulated professional' and a family trust in which all of the beneficiaries are children of the regulated professional).

The ASC proposal includes provisions aimed at ensuring that the use of a corporate vehicle to deliver trading or advising services does not impact the registrant-client legal relationship for both firms and individual sales representatives. These provisions are designed to ensure that the use of the sales representative's corporation does not:

- impact the flow of liability between an individual registrant and clients and between individual sales representatives and their firm;
- impact the registrant-client legal relationship; and
- impact the application of provincial securities laws.

Option 2: Statutory Incorporation Framework:

Advocis Legislative Proposal

In 2008, Advocis, an industry association of financial advisers and planners, put forward a legislative proposal for the incorporation of financial advisers.

The Advocis proposal would establish broad parameters and specific conditions for incorporation that are largely based on regulatory requirements found in the life insurance sector.

The Advocis proposal does not impose restrictions on directors or shareholders or on their shareholdings. Under this proposal, both registrants and non-registrants could be directors and shareholders of a corporation providing trading and advising services.

Advocis maintains that adequate reporting requirements to assess the suitability of shareholders, coupled with legislative requirements to ensure the proficiency, suitability and personal liability of an individual registrant employed or otherwise engaged by a sales representative's corporation, would eliminate the need for restrictions on shareholder structures for an incorporated sales representative.

The Advocis proposal seeks to preserve the liability and obligations of the individual sales representative/incorporated sales representative to the client. Advocis has suggested that the personal liability issue could be addressed in a variety of ways by providing that:

- The acts of the sales representative's corporation are deemed to be the acts of the sales representative;
- The liability of an individual sales representative for a claim arising out of his or her obligations as a representative is not affected by the fact that the sales representative is providing trading or advisory services through a corporation;
- An individual sales representative is jointly and severally liable with the representative corporation for all liability claims made against the corporation arising from activities of a sales representative for errors or omissions that were made or occurred while the representative was a shareholder of the corporation;
- The liability of an individual sales representative cannot be greater than his or her liability would be in the circumstances if he or she were not practicing through the corporation;
- Individual sales representatives and their corporations would be obligated to maintain errors and omissions insurance, as is currently required on the insurance side.

Option 3: Redirection of Remuneration to Unregistered Corporations

The recent approval by most provincial securities regulators of modified MFDA Rule 2.4.1, subject to specific conditions, allows an individual sales representative of a MFDA member to have his or her commissions paid directly to his or her non-registered corporation.

Industry groups have raised concerns that the recent MFDA rule change will create an unlevel playing field between mutual fund sales representatives and other securities sales representatives.

A more level playing field for registered sales representatives could be achieved if IIROC were to modify its rules and allow individual sales representatives of IIROC members to redirect their commissions to non-registered corporations.

Options 1 and 2 would assist in clarifying the tax treatment of incorporated sales representatives, but they also involve potential tax revenue losses that governments will need to consider.

This option has the merit of not adversely affecting the flow of liability between the individual sales representative and his or her clients and between the sales representative and his or her sponsoring firm. It would also establish a level playing field between MFDA and IIROC sales representatives. However, this option does not address the potential tax risk inherent in the redirection of remuneration from trading or advisory services to a non-registered corporation.

QUESTIONS

Below are questions relating to the options presented in this paper, which may help to focus your submission. Please provide responses to as many questions as possible. At the same time, if you have other comments not addressed by these questions, please include them. Your responses will help us better identify and understand the implications of the different options.

1. Should governments allow a broader range of registered dealers and advisers to redirect remuneration to a non-registered corporation?
2. Should governments allow individual representatives of registered dealers and advisers to incorporate?
3. If yes to question 2, which incorporation option would in your view be the most effective and balanced alternative?
4. Are there other provisions or options that should be considered to ensure that the use of a corporation continues to preserve the registrant-client legal relationship for both firms and individual sales representatives and provides for proper oversight of individual sales representatives by their registered dealer and adviser?
5. Do you have any concerns or comments about potential income tax consequences or regulatory obstacles regarding each option?

6. Do you have any concerns or comments about the potential impact of the incorporation options on investor protection?

DEADLINE FOR COMMENTS

You may provide written comments in hard copy or electronic form. The comment period expires on **February 25, 2011**.

Please send your comments only to the following addresses.

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Please note that all comments received during the comment period will be published on the website of Alberta Finance and Enterprise (www.financealberta.ca) and will be provided to the following government organizations:

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Alberta Finance and Enterprise
Saskatchewan Justice
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