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Association canadienne des courtiers de fonds mutuels

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MFDA Bulletin

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Review of Compensation, Incentives and Conflicts of Interest

In 2016, MFDA compliance staff performed a targeted review of Member compensation and incentive programs. The attached report describes the work performed by the MFDA to assess Member compensation and incentive programs, the key findings from our review and our next steps.

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Review of Compensation, Incentives and Conflicts of Interest

December 2016

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Executive Summary

In 2016 MFDA compliance staff performed a targeted review of Member compensation and incentive programs. The review was performed in collaboration with staff from the Investment Industry Regulatory Organization of Canada ("IIROC") and various provincial securities regulators who each reviewed the incentive practices of registered firms over which they exercise direct regulatory oversight. This report describes the work performed by the MFDA to assess Member compensation and incentive programs, the key findings from our review and our next steps.

The objectives of the MFDA review were to gain a more detailed understanding of Member compensation and incentive programs, assess compliance with certain sections of National Instrument 81-105 (Mutual Fund Sales Practices) and identify any compensation or incentive practices that might lead to mis-selling or unsuitable advice.

We believe it is reasonable for firms to incentivize their staff and reward performance that contributes to the firm's financial success. However, compensation practices and incentive programs should not encourage unsuitable or inappropriate advice. In addition, compensation and incentive practices must comply with National Instrument 81-105 which prohibits dealers from providing incentives that favour mutual funds of one mutual fund company over mutual funds of other mutual fund companies. Our review identified a variety of compensation and incentive practices that have the potential to affect the behavior of dealer representatives. Publications issued by other regulators have described a number of these compensation and incentive practices. [1] However, this report focuses only on certain practices that, in the view of MFDA staff, raised greater regulatory concerns.

We identified a small number of Members who had compensation structures that, in our view, did not comply with National Instrument 81-105. Specifically, we identified Members who provided incentives that favoured proprietary mutual funds or mutual funds of a particular fund family over other mutual funds. These cases have been referred to our Enforcement Department. All of the Members have been responsive to addressing the findings and are taking action to amend their compensation structures and eliminate the incentives favouring proprietary funds.

We also identified compensation and incentive practices that, in our view, increase the risk of mis-selling and unsuitable advice. Specifically, we identified compensation structures that provided additional incentives to recommend deferred sales charge ("DSC") funds. We expect firms to properly manage these risks and consider amendments to their compensation structure and we will continue to review compensation structures in our examinations.

Lastly, our review highlighted the fact that while National Instrument 81-105 only applies to mutual funds, compensation and incentive concerns are not limited to the distribution of mutual funds. Dealers receive compensation and benefits from issuers of other investment products, such as exempt securities, where the rate of compensation is often significantly higher than the compensation paid for mutual funds. In addition, in many cases the types of compensation or benefits dealers receive from other investment products or referral arrangements are the types of compensation or benefits that are prohibited by National Instrument 81-105 for mutual funds.

[1] CSA Staff Notice 33-318 Review of Practices Firms Use to Compensate and Provide Incentives to their Representatives, Financial Services Authority – Risks to Customers from Financial Incentives

The MFDA Review

In March of 2016 all MFDA Members were required to submit information respecting the compensation structure for their representatives including all incentive and rewards programs. Firms were asked to provide specific information, which included the following:

1) Any production thresholds or tiers that entitle representatives to higher compensation in the form of a higher commission payout, higher base salary or higher bonuses. If a set compensation grid exists based on certain established thresholds, provide a copy of the grid.
2) If the firm sells both funds of related or connected issuers and arms-length (third party) funds identify any additional incentives to sell funds of related/ connected issuers. e.g. higher commission payout, bonuses, points or rewards systems, sales contests, premiums places on the price paid for an Approved Person's book of business.
3) A list of any issuers that provided compensation to the firm other than sales commissions, trailing commissions or payments received from mutual fund companies in compliance with Part 5 of National Instrument 81-105. This information request covered all issuers, not just mutual funds, and firms were required to provide details of all compensation received. e.g. fees or payments to make a product available for sale ("shelf fee" or "due diligence fee"), shares/ options or warrants, performance fees, production bonuses or rewards including trips.
4) Complete details on all referral arrangements and the compensation received from such arrangements.

MFDA staff reviewed the submissions and performed appropriate follow-up procedures to analyze the firms' compensation structures, assess compliance with applicable requirements and identify any regulatory concerns. The key findings from our review are described below.

Key Findings

1. Incentives to Favour Proprietary Funds

In most cases, we found that the documented compensation grids and incentives programs in place at firms were product neutral and contained no documented incentives that favoured proprietary products or mutual funds of one mutual fund family over others.

We noted a small number of cases where firms had compensation structures that included additional incentives to favour proprietary funds or mutual funds of a specific fund family. These compensation structures, in our view, did not comply with Part 4 of National Instrument 81-105 which prohibits dealers from providing incentives to their representatives to recommend mutual funds of one mutual fund family over mutual funds of another mutual fund family. These findings have been referred to the MFDA Enforcement Department. All of the firms have been responsive to addressing the findings and are taking action to amend their compensation structure and eliminate the incentives favouring proprietary funds.

In each of the identified cases, the firms had multi-dimensional compensation structures where one or more particular elements of the compensation structure favoured proprietary funds or funds of a particular fund family. Examples included certain commission bonuses or additional commissions that only applied to sales of proprietary funds, rewards programs where proprietary sales received more reward credits and retirement programs that were structured in a way that created an incentive that favoured proprietary funds.

Some of the firms had previously exclusively sold proprietary funds and had only recently added third party funds to their product shelf. However, they did not amend certain aspects of their compensation structure that contained additional incentives that only applied to proprietary funds. By leaving these incentives in place and failing to extend them to third party funds, the firms, in our view, did not comply with National Instrument 81-105.

Illustrative Examples[2]

Illustrative Example A

Firm A sold both proprietary funds and third party funds. The firm had two programs that favoured two specific mutual fund companies including one proprietary fund company.

Firstly, there was a supplemental commission program that paid additional commissions on the prior year's commission revenue. However, only funds from the two specific fund companies were eligible for this program.

Secondly, the firm had a program to purchase a representative's book of business upon retirement. Only mutual funds of the two specific fund companies were eligible for the program thereby creating an incentive for advisors to recommend those funds.

Illustrative Example B

Firm B sold both proprietary and third party mutual funds. Representatives received a base percentage payout on commissions for both proprietary and third party mutual funds. (e.g. 50%) Representatives could also receive an additional commission bonus based on a payout rate of 20% to 70% of the base commission rate. The additional bonus payout rate was determined based on proprietary sales only and did not include third party funds, thereby creating an incentive that favoured proprietary funds.

In addition, the firm had a rewards program that provided representatives with non-monetary rewards such as access to professional support and resources. The recognition credits for the program were based only on proprietary sales.

2. Incentives That May Lead to Mis-Selling

Incentive programs that are not properly structured and controlled can encourage representatives to act inappropriately, including making investment recommendations that may not otherwise be suitable for a client. Mis-selling can also include situations where representatives seek to structure client transactions in a way that allows the representative to achieve the greatest recognition or benefit even though there may be negative consequences for clients. Set out and discussed in greater detail below are examples of certain incentive practices that increase the risk of mis-selling.

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[2] The examples documented in this report are provided for illustrative purposes only and may not fully summarize all aspects of the underlying fact situations.

2.1 Incentives that Favour Deferred Sales Charge Funds

We noted, in rare cases, some very direct incentives that favoured the sale of deferred sales charge funds including firms who had commission bonuses based exclusively on DSC sales and rewards programs with additional reward credits specifically for DSC sales.

We also noted certain compensation grids that, indirectly, might be more likely to incent representatives to favour DSC funds. When determining the compensation grid for representatives, firms typically use one of two approaches, to determine the percentage of compensation paid out to the representative. The compensation payout is either determined by: (1) the amount of the representative's client assets under administration; or (2) by the amount of commissions the representative generated during the year. While compensation grids that are based on commissions generated are very common throughout the industry, this type of grid may place more emphasis on generating transactional commissions particularly DSC commissions.

Furthermore, we noted compensation grids where the payout on sales commissions was higher than trailing commissions. At one firm, certain representatives received almost no payout on trailing commissions. With this structure, the advisor may be strongly incented to generate transactional commissions such as DSC commissions, as they receive significantly less compensation from trailing commissions.

Illustrative Example A

A firm had a payout grid where some representatives received as little as 10% of the trailing commissions on their client accounts. New sales commissions such as DSC were paid out to the representative at a rate of between 40% and 75%. The firm also had various bonus programs based on qualifying production which excluded funds with initial sales commissions of less than 1%.

Illustrative Example B

A firm offered a year-end bonus whereby representatives received a 10% increase in their commission payout where they had sales in excess of $500,000 in DSC or low load funds. Representatives also received an additional production bonus for each $1,000,000 in sales of DSC or low load funds.

2.2 Recognition Programs and Rewards Systems

Several firms have rewards programs where advisors who achieve certain criteria are eligible for both recognition and rewards. The advisors who achieve the criteria commonly receive a distinction such as "President's Club" and a reward such as an invitation to attend an exclusive conference event. The criteria are typically based on revenue or growth in client assets either relative to other representatives or as compared to set targets. Firms have to be mindful of the behavior that such programs may incent and recognize that the intended and unintended effects of these incentives can be complex.

We noted an example illustrated below where representatives may have split large client transactions into multiple transactions to increase their chances of qualifying for the recognition program. While the firm self-identified the issue and took prompt steps to revise the incentive program, the example illustrates that firms need to avoid establishing incentive programs that can incent inappropriate behavior and carefully monitor existing programs.

Illustrative Example

A firm had an incentive program whereby qualifying representatives and supervisors received both recognition and reward. The criteria for determining which representatives qualified for the program included mutual fund sales production. In determining recognition credits for the program there was a daily transaction limit per account. The firm identified the fact that certain representatives may have split large client transactions into multiple smaller transactions over several days in order to receive more recognition credits for the purposes of qualifying for the program. By splitting large client transactions into multiple smaller transactions, clients may have potentially received less favorable pricing on their mutual fund purchases.

The recognition or reward achieved under firms' rewards programs is often non-monetary in nature. Examples include additional professional development, educational support or trips to exclusive conferences.

In some cases, the recognition programs may include titles that are bestowed upon a representative based on their sales production or level within the sales hierarchy. We have identified a small number of cases where these titles were misleading and suggested an executive level position such as vice-president, president, owner or chief executive officer. While firms stated that these titles were strictly for internal use and were not to be used publicly or when communicating with clients, we have found instances where these titles were used by advisors in their promotional activities. The use of misleading titles is contrary to MFDA Rules and such titles should not be used under any circumstances including as part of an internal recognition program.

3. Compensation on Other Investment Products and Arrangements

While National Instrument 81-105 only applies to mutual funds, we noted that other investment products and referral arrangements can raise sales practice and compensation concerns. In many cases, the compensation associated with these other investment products and arrangements would be prohibited by National Instrument 81-105, if the instrument were to apply.

3.1 Other Investment Products

We observed that the compensation paid on other investment products, particularly exempt securities, is often significantly higher than the compensation paid on mutual funds. The sales commissions on many exempt securities are 10% and sometimes higher.

In addition, there are various other monetary and non-monetary benefits provided to dealers and representatives by issuers of other investment products. Many of these benefits are not permitted for mutual funds and include:

- Shelf fees or due diligence fees;
- Dealer participation fees;
- Shares, options or warrants in the issuer;

- Bonus commissions;
- Performance fees; and
- Out-of-country sales conferences and other rewards.

Illustrative Example

The issuer compensates exempt market dealers through one of two plans selected by the exempt market dealer. The compensation is either a 10% initial commission plus an annual 1% trailing commission (commencing at 60 months) or a 7% initial commission plus a 1.5% annual trailing commission (commencing at 36 months). Exempt market dealers are also "reimbursed for reasonable expenses incurred in connection with the offering". The amounts of these payments vary but as an example a dealer received initial due diligence fees plus an additional 1% of the amounts raised as reimbursement for administrative costs and marketing expenses.

3.2 Referral Arrangements

We also noted that referral arrangements between dealers and portfolio managers are commonly used to provide investment services to retail investors. In these arrangements, the dealing representative refers the client to a portfolio manager for investment advice and services. The dealing representative should not be providing any ongoing advice with respect to the client assets at the portfolio manager. Despite this fact, the structure and amount of compensation received on these referral arrangements is often comparable to a mutual fund trailing commission. The referral fees are often 50% of the portfolio manager's management fees. This translates to referral fees of .50%-1.5% of client assets per annum. In some cases the compensation exceeds these levels as illustrated in the examples below.

Furthermore, as these arrangements are not subject to National Instrument 81-105, the restrictions on compensation and benefits that apply to mutual fund sales do not currently apply, in a direct manner, to these arrangements. For example, compensation arrangements between referring parties that include bonus commissions or initial incentives to enter the arrangement are not specifically prohibited for referral arrangements as they are in a distribution agreement between a dealer and a mutual fund company. There is a risk that firms may look to structure sales arrangements as referral arrangements rather than distribution agreements to avoid certain regulatory requirements.

Illustrative Example A

A referral arrangement with a registered portfolio manager provides that where clients are referred to the portfolio manager, the referring agent will receive referral fees equal to 100% of the portfolio manager's management fee in the first year and 1/5th of the management fee in subsequent years.

Illustrative Example B

A referral agreement with a registered portfolio manager provides that the referring agent will receive referral fees as follows:

- *Up to 1.45% per annum on the first $2 million in assets under management per client;*
- *Up to 1.35% per annum for client assets between $2 million to $5 million;*
- *Up to 1.25% per annum on client assets over $5 million.*

Illustrative Example C

A referral arrangement with a portfolio manager provided that the referring agent would receive a referral fee equal to 1.00% (approximately 60% of the investment management fee paid to the portfolio manager) on an ongoing basis. Referring agents also received shares in the portfolio manager with a value of approximately 1% per $10 million of client assets referred.

Next Steps

1. We will take regulatory action where Members do not comply with the requirements of MFDA Rules or securities legislation, including cases where firms provide incentives that favour proprietary funds and we may also refer matters to provincial securities regulators.
2. We will continue to assess Member firms' compensation and incentive practices and their controls to adequately manage conflicts through our regular examinations and other regulatory processes.
3. With respect to incentives that favour DSC funds, there is ongoing work by the Canadian Securities Administrators ("CSA") addressing mutual fund fees. The outcomes of this work, including any potential reforms on compensation and mutual fund fees will be directly relevant to these issues. The MFDA will continue to monitor these developments and take additional steps as necessary.
4. With respect to concerns regarding compensation and incentives associated with non-mutual fund investments and referral arrangements, we will refer these issues to provincial securities regulators and participate in discussions relating to compensation reform and whether the requirements of National Instrument 81-105 should be extended to other products or arrangements.
5. We will continue to work with other securities regulators to understand their findings related to compensation and incentives and work collaboratively to address common issues.