Policy Brief

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Subject: Chargebacks in Investment Fund Sales: Shifting Employer Risk to Employees in Violation of Labour Standards and Regulatory Principles?

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Ontario Securities Commission
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Executive Summary

This policy brief addresses a significant and underexamined issue within the Canadian investment industry: the practice of using chargebacks to recover commissions from advisors following early client redemptions. While regulatory concern has focused appropriately on the client harm caused by such arrangements, it is equally vital to recognize that chargebacks may represent an unlawful and inequitable transfer of business risk from employer to employee.

This practice potentially violates provincial labour standards legislation—notably, the Employment Standards Act, 2000 (Ontario)—as well as common law contractual principles and public policy expectations. This brief urges the Canadian Securities Administrators (CSA) to consider a prohibition on chargebacks not only on investor protection grounds but also as a necessary response to unlawful employer conduct in regulated environments.

The Problem: Employer Cost-Shifting Disguised as Compensation Design

The chargeback model requires investment advisors to repay commissions received on mutual fund sales if the client redeems the investment within a predetermined holding period. This arrangement places advisors in direct economic conflict with their clients, compromising impartial judgment and potentially breaching the Client Focused Reforms (CFRs). But beyond regulatory conflict of interest, this practice may also:

- Breach employee wage protection laws
- Undermine fair contracting standards for independent contractors
- Mislead clients about who is truly responsible for acting in their best interest. The client, to whom a fiduciary duty may be owed under Canadian law, likely believes that investment recommendations are made solely to benefit them. But did the client understand why this particular investment structure—which may carry chargeback risk—was chosen over lower-cost alternatives? Was the investment selected to satisfy the interests of the firm over the clients? The legal obligation to act in the client's best interest ultimately rests with the employer—the firm with whom the client has a contract—not with the employee whose pay may be clawed back after the fact.
- Erode workplace morale and organizational integrity

The issue is not merely one of industry preference or sales practice; it is one of legal compliance and employer accountability.

Legal Framework

1. Employment Standards Legislation (Ontario ESA, 2000)

Section 13 of the ESA provides:
"An employer shall not make a deduction from an employee’s wages unless (a) the deduction is authorized by statute or a court order; or (b) the employee has provided written authorization after the deduction becomes necessary."

Advance authorizations in employment contracts are insufficient.

If the advisor is an employee, the deduction of previously paid wages (e.g., commissions) due to early client redemptions is likely illegal unless new written authorization is obtained post-event.

2. Independent Contractor Protections under Common Law

Even where advisors are treated as independent contractors, enforcement of chargeback clauses is subject to:

- Unconscionability doctrine (e.g., Douez v. Facebook, 2017 SCC 33)
- Good faith performance in contracts (Bhasin v. Hrynew, 2014 SCC 71)
- Public policy limits on contracts that frustrate statutory or regulatory protections

Courts may find chargeback clauses unenforceable if they:

- Were imposed under a power imbalance
- Conflict with regulatory duties to clients
- Penalize advisors for events beyond their control

3. Regulatory Conflict: Client Focused Reforms (NI 31-103)

CSA Notice and Rule amendments under NI 31-103 mandate that:
“Registrants must resolve conflicts of interest in the best interest of the client… Compensation arrangements must not incentivize behavior that puts the interests of the firm or representative ahead of the client.”

Chargebacks inherently distort professional judgment and interfere with the registrant’s CFR obligation. This conflict cannot be resolved through disclosure or internal controls.

Broader Concerns

Chargebacks reflect a broader trend of cost externalization by firms, creating a structurally coercive environment for advisors. This:

- Exposes advisors to financial penalty for client-driven decisions
- Encourages advisors to retain unsuitable assets to avoid personal financial harm
- Compromises both client and employee protection mandates

Policy Recommendation

Given the overlap between securities regulation and employment law, the CSA should:

1. Formally prohibit chargebacks under NI 31-103 as incompatible with the CFRs

2. Coordinate with provincial labour ministries to assess the legality of chargeback practices under wage protection laws
3. Clarify in CSA Staff Notices that compensation recovery clauses must comply with applicable employment standards
4. Investigate whether such practices amount to systemic wage suppression or improper delegation of employer obligations

Conclusion

Chargebacks not only harm investors but may also violate labour rights. The CSA must act decisively to prevent these practices from continuing under the guise of compensation policy. The integrity of capital markets depends not just on protecting clients, but also on upholding lawful and ethical treatment of registrants.

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