CANADIAN SECURITIES ADMINISTRATORS' NOTICE 33-304

CSA Distribution Structures Committee Position Paper

The Canadian Securities Administrators ("CSA") are publishing the Position Paper of the CSA Distribution Structures Committee (the "Committee"). The CSA established the Committee in 1997 to develop policy positions to address the regulatory issues that have arisen due to changes that are occurring in the manner in which securities firms structure their businesses to facilitate the commercial provision of securities trading and advising services to the public. The Committee is comprised of representatives of the securities commissions of British Columbia, Alberta, Saskatchewan, Ontario, Québec and Nova Scotia.

An important underlying principle of the Paper is that the positions put forward are intended to apply, subject to the observations below regarding Québec, to members of all existing and proposed self-regulatory organizations ("SROs"). The positions set out in the Paper are expected to form an integral part of the rules proposed by the new Mutual Fund Dealers Association ("MFDA"). The CSA intend to work closely with the MFDA and other SROs to implement the positions set out in the Paper.

In Québec, the introduction of the regulatory regime in Bill 188 provides for a sharing of responsibility between the Commission des valeurs mobilières du Québec ("CVMQ") and the Bureau des services financiers. Consequently, the CVMQ must apply the positions discussed in the Paper by taking into consideration current practices related to the distribution of financial products other than securities, as well as existing legislative provisions.

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Executive Summary

Introduction

The Distribution Structures Committee (the "Committee") was established in 1997 by the Chairs of the Canadian Securities Administrators (the ACSA@). The Committee=s mandate is to develop policy positions for the CSA. Those positions are to address the regulatory issues that have arisen due to changes that are occurring in the manner in which securities firms structure their businesses to facilitate the commercial provision of securities trading and advising services to the public. An important underlying principle of the Position Paper is that the positions put forward are intended to apply, subject to the observations below regarding Québec, to all securities regulatory systems including all existing and proposed self-regulatory organizations (ASROs@).

The term Adistribution structures@ refers, in part, to how securities firms organize their businesses. Under the traditional structure, a securities firm markets and delivers its services through its partners, officers, or employees. Under this structure, the dealer =s liability for the actions of its salespersons and its duty to supervise the actions of those salespersons is clear. There is, however, pressure from the securities industry to allow the use of non-traditional structures. In some cases firms have already implemented these structures. These non-traditional structures do not always honour the regulatory principles of effective supervision, legal responsibility to the client, access to books and records, *etc.* and, therefore, regulatory concerns arise.

The Committee has limited the scope of its policy positions by the use of the expression Afinancial services, not subject to another regulatory regime@. The Committee recognizes banking, insurance, and, in Québec, deposit taking activities, mortgage brokerage, real estate brokerage and financial planning activities, as financial services that are subject to another regulatory regime.

Commission des valeurs mobilières du Québec

In Québec, the introduction of the regulatory regime in Bill 188, *An Act respecting the distribution of financial products and services*, provides for a sharing of responsibility with regard to regulating the distribution of mutual funds, insurance products and financial planning services between the *Commission des valeurs mobilières du Québec (CVMQ)* and the *Bureau des services financiers (BSF)*. Bill 188 entrusts the supervision of mutual fund dealers, insurance brokers and agents, and financial planners to the BSF, and permits all of these activities to be carried out at the same firm. Bill 188 imposes responsibility for the activities it covers on the dealer through registration and, on the representative, through certification.

Consequently, the CVMQ must apply the positions discussed in this report by taking into consideration practices currently in use related to the distribution of financial products other than securities and existing legislative provisions.

Background

The Canadian securities regulatory regimes assume that the relationship between a securities firm and its sales staff is that of employer and employee. The regimes deal with regulatory and accountability issues on the basis of this assumption. Regulatory issues arise from certain proposed non-traditional structures that are not based on the relationship of employer and employee.

Principles for Distribution of Securities

In considering whether non-traditional structures should be allowed, the Committee considered whether those structures are consistent with the following principles: the dealer must be legally responsible for the acts of its salespersons; the dealer must exercise an appropriate level of supervision over its salespersons; 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 salespersons 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.

Short term goals

The following are the Committee=s short term goals and are fundamental to the Committee=s deliberations: all financial services, not subject to another regulatory regime, are to be conducted through the dealer; the dealer must be liable for all financial service activities, not subject to another regulatory regime, conducted by its salespersons; and the books and records of the dealer and all salespersons must be available for inspection at all times by the dealer and regulators.

Long Term Goals

The following are the long term goals identified by the Committee that are to be achieved in consultation with other regulators: all financial service activities conducted by a dealer=s salespersons must be conducted through, and appear on the books of the dealer, or other appropriately registered or licensed and regulated entity; and the

dealer must be liable for all financial service activities between the dealer=s salespersons and its clients.

Discussion and Positions

The Committee reviewed six specific subjects: dual employment, securities sold under exemptions, trade names, referral arrangements and commission splitting, financial planning activities by registrants, and the legal relationships that exist between dealers and their salespersons.

A summary of the Committee=s position on each of these subjects follows. For a full discussion of the issues and positions please refer to the Position Paper.

> Dual Employment: Dual employment will be allowed, provided that the salespersons= other employment does not interfere with their duties and responsibilities as salespersons and provided that the dealer is responsible and liable for all of the financial service activities of the salespersons that are not subject to another regulatory regime.
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> Securities Sold Under Exemptions: Restricted dealers and salespersons will be permitted to sell only those securities for which they are expressly registered, as well as deposit instruments and government debt instruments.
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> Trade Names: Trade names and trademarks will be permitted to accompany, but not replace, the full legal name of the dealer on materials that are used to communicate with the public, provided that the following condition, and others specified in the Position Paper, are met: all trade names and trademarks through which a salesperson conducts registerable activities and financial service activities that are not subject to another regulatory regime must be registered to the dealer.
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> Referral Arrangements and Commission Splitting: Referral arrangements will be permitted only between dealers or between dealers and entities that are licensed or registered under some other regulatory system that is acceptable for the purpose of referral arrangements (Aacceptable entity@), and then only if certain conditions specified in the Position Paper are satisfied. These conditions include the requirement that there be a written agreement governing the payment of referral fees between the dealers, or the dealer and the acceptable entity. The agreement cannot be between the salespersons themselves.

Financial Planning Activities by Registrants : Salespersons who provide financial planning services must do so through the dealer that sponsors their securities registrations. They must also comply with certain other requirements that are detailed in the Position Paper, including the requirement that salespersons must satisfy minimum proficiency standards.

Legal Relationships and Business Structures

The following items deal with legal relationships between dealers and salespersons and whether business structures based on those relationships are acceptable, having regard for the regulatory principles on which the Position Paper is based.

Dealer as employer and salesperson as employee : A relationship between a dealer and its salesperson that is properly characterized as that of employer and employee is acceptable to the Committee. The Committee, however, also takes the position that the liability of a dealer for the acts of its salesperson should be governed by a regime of comprehensive statutory liability. This regime will require legislative amendments.

Dealer as principal and salesperson as agent : A principal and agent relationship between a dealer and a salesperson is acceptable provided that the following, and other conditions discussed in the Position Paper, are met: the dealer must be responsible for and supervise all of the activities of its salespersons that relate to the delivery of financial services, other than financial service activities subject to another regulatory regime.

Independent contractor: Salespersons will not be permitted to carry out their financial service activities on behalf of a dealer where they are acting as independent contractors.

Incorporation without registration : Subject to the discussion that follows concerning introducing and carrying dealer structures and service provider structures, salespersons will not be allowed to incorporate in order to conduct registerable activities and financial service activities that are not subject to another regulatory regime.

Acceptable Business Structures

It is the position of the Committee that the following are acceptable business structures:

> Dealer as employer and salespersons as employees, or dealer as principal and salespersons as agents: A structure wherein the dealer is the employer and the sales force is composed of employees is acceptable. Where the dealer is the principal and the salespersons are agents, the structure will also be acceptable, but only if the conditions set out in the Position Paper=s discussion of salespersons as agents are satisfied.
>
> Service provider business structure: Unregistered corporations may provide certain services to a dealer and its salespersons, provided that the conditions discussed in the Position Paper are satisfied. Those conditions include the requirement that the dealer=s ultimate responsibility and liability to clients must not be affected by these arrangements.
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> Introducing and carrying dealer model: Dealers may only enter into arrangements involving multiple corporations when all of those corporations are registered in an appropriate category of dealer or the arrangement is in accordance with the service provider model.

Implementation

Some of the Committee=s positions are expected to be implemented by policy and some by rule and certain requirements may require legislative amendments. Much of the detail will be left to the SROs to determine and implement by way of by-laws or regulations. It is clear that the positions may have a significant impact on the manner in which registrants organize and conduct their business operations. The Committee believes that its concerns are well-founded, and its positions flow from those concerns.

CSA Distribution Structures Committee: Position Paper, August 1999

Introduction

The Committee

The Distribution Structures Committee (the "Committee") was established in 1997 by the Chairs of the Canadian Securities Administrators (the ACSA@). The Committee consists of staff members from several Commissions, including the Chair of the Nova Scotia Securities Commission, and it is chaired by Renée Piette of the Commission des valeurs mobilières du Québec (ACVMQ@).

Securities firms adopt business structures to facilitate the commercial provision of securities trading and advising services to the public. There are changes occurring in those structures. The Committee=s mandate was to develop policy positions for the CSA that will address the regulatory issues that have arisen due to these changes. Consideration was, therefore, given to whether the evolution of these structures has created concerns about the integrity and efficacy of the existing regulatory system, and if so, to determine how those concerns could be addressed. This Position Paper contains the Committee=s response to that mandate. The positions set out in this Position Paper apply to all existing and proposed self-regulatory organizations (ASROs@).

It was the Committee=s overall goal to harmonize the relevant regulatory requirements in Canada. Nonetheless, there are now, and may continue to be, particular requirements in particular jurisdictions that will govern. Many, but not all, of those requirements are noted in footnotes to this Position Paper. The Committee believes that most of the positions contained in this Position Paper reflect existing regulatory provisions and do not represent changes to the basic legislative regimes that are in place in Canada. This position should not, however, be interpreted to mean that the Committee believes that all the structures currently in use by securities firms comply with the requirements of the existing regulatory provisions.

Commission des valeurs mobilières du Québec

In Québec, the introduction of the regulatory regime in Bill 188, *An Act respecting the distribution of financial products and services*, provides for a sharing of responsibility with regard to regulating the distribution of mutual funds, insurance products and

financial planning services between the CVMQ and the *Bureau des services financiers (BSF)*. Bill 188 entrusts the supervision of mutual fund dealers, insurance brokers and agents, and financial planners to the BSF, and permits all of these activities to be carried out at the same firm. Bill 188 imposes responsibility for the activities it covers on the dealer through registration and, on the representative, through certification.

Consequently, the CVMQ must apply the positions discussed in this report by taking into consideration practices currently in use related to the distribution of financial products other than securities and existing legislative provisions.

Distribution Structures

The term Adistribution structures@ covers a number of subjects. It refers, in part, to how firms that sell securities to the investing public organize their business. For example, a firm may arrange its business as an employer (the firm) and employees (the salespersons).[1] The term also refers to arrangements between securities firms and others. For example, an arrangement whereby a securities firm pays to another organization or person a referral fee for client referrals is a part of the securities firm =s distribution structure. The term also refers to arrangements whereby a securities firm contracts out to other organizations the performance of various functions associated with the conduct of the firm=s business.

Historically, a securities firm marketed and delivered its services through its partners, officers, or employees. This is the traditional distribution structure. Under this structure, the firm is conducting the business; it is doing so through its employees or Aservants@, and, accordingly, all of those employees are appropriately registered. That

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[1] The terms Asalespersons@ and Asalesperson@ are used throughout this Position Paper. It is the Committee=s intention that these terms be interpreted to include all personnel that interact with clients for the purpose of trading or advising in securities.

is, individuals are registered as salespersons and the entity that employs them is registered as a dealer. The firm is responsible and liable for the acts of those employees performed in the discharge of their employment with the firm.

There is pressure from the securities industry to allow the use of non-traditional structures. In some cases firms have already implemented these structures. The desire to use non-traditional structures is driven, in part, by perceived, and actual, tax and operational efficiencies for dealers and salespersons and an appetite for a higher degree of autonomy and independence for salespersons. This desire has been evidenced over the past number of years by the appearance of new structures such as independent contractors and franchises, and arrangements such as referral fees. Securities regulation places great importance on principles such as effective supervision, legal responsibility to the client, access to books and records, *etc.* These new structures do not always honour those principles and, therefore, regulatory concerns arise.

The liability of the dealer for the acts of its salespersons is an important part of investor protection under Canadian securities law. Where that liability is clouded, investor protection may be compromised. For example, the responsibility of a dealer for the acts of its franchisees or independent contractors may not be clear and regulatory concerns, therefore, will arise. Another important component of the Canadian investor protection programme is the requirement that all persons or companies that are acting in furtherance of trades in securities be registered with the appropriate securities regulatory authority. When securities firms accept referrals from non-registered persons or companies, or persons and companies that, while registered, are not registered for trading or advising in the securities in question, concerns arise about persons and companies that are not appropriately registered acting in furtherance of trades and about the quality of advice the investor is receiving.

The Canadian securities legislative regimes classify firms that trade in securities for the investing public into several different categories. These are the categories of dealers, and they include: full service securities firms that are members of a self-regulatory organization (ASRO@), securities firms that are not members of an SRO, and mutual fund dealers. Individuals are, subject to proficiency requirements, registered as representatives of these firms. Every registered representative must be sponsored by an appropriately registered dealer. The current registration regime for individuals and businesses that distribute securities to the investing public in Canadian jurisdictions assumes that the traditional master and servant relationship exists between the firm

and its salespersons.[2] With such a relationship in place, the reporting lines are clear; it is clear who is supervising whom; it is clear to whom the books and records belong; it is clear who is liable for the acts of the salesperson; and so on. The Committee is aware that distribution structures exist in the Canadian securities industry that may not be based on the legal relationship between the dealer and its salespersons of employer and employee. The Committee considered whether these structures replicate the clear lines of responsibility *etc*. outlined above, and, if they did not, what regulatory accommodation would be required to balance the industry=s desire for non-traditional structures and the Committee=s concerns for investor protection. As will be discussed, the Committee has determined that certain of these structures cannot be reconciled with the existing regimes. Further, some structures cannot be accommodated even when modifications are made to the regimes, where those modifications are consistent with the regulatory principles that are articulated in this Position Paper.

Committee Deliberations

In this Position Paper, the Committee limits its policy positions by the use of the expression Afinancial services, not subject to another regulatory regime@. The Committee=s positions are not intended to disrupt existing regulatory relationships. Rather, the Committee=s intention is to ensure that the regulatory regime is complete. The Committee recognizes banking, insurance, and, in Québec, deposit taking activities, mortgage brokerage, real estate brokerage and financial planning activities as financial services that are subject to another regulatory regime. The Committee is looking forward to working with the insurance industry=s regulators, and others, to ensure harmonization and cooperation in the regulation of dually-licensed registrants.

The Committee began its deliberations by defining the structures that exist in the securities industry, including the traditional structure of firm employer and salesperson employee and the non-traditional structures. The non-traditional structures considered included: non-registrants sharing in registrants= commissions; registrants who are not qualified to deal in specific products referring clients to registrants who are registered to deal in those products and then sharing in the second registrant=s commission; registrants conducting other financial businesses through unregistered corporations; registrants using trade names other than the name of the securities firm through which

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[2] The expression Amaster and servant@ has a precise legal definition but it is not an expression in common use. To facilitate ease of reference, the more common expression Aemployer and employee@ will be used in this Position Paper.

they are registered; independent contractors; franchises; and service providers.

The Committee focussed its attention on the implications that the use of these structures has on the proper supervision of salespersons by dealers; on dealer capital and bonding requirements; on record keeping functions; and on dealer liability. The Committee then considered how, if at all, the regulatory system should be altered.

During its deliberations the Committee met with several industry and regulatory organizations, including the Canadian Investor Protection Fund, the Investment Dealers Association of Canada, the Investment Funds Institute of Canada, and the Mutual Fund Dealers Association of Canada. The Committee thanks all of these organizations for their input.

Background

The Canadian securities regulatory regimes assume that the relationship between the securities firm and its sales staff is that of employer and employee. The regimes deal with regulatory and accountability issues on the basis of this assumption. There are, however, pressures being exerted by the securities industry to allow firms to operate with non-traditional structures. The IDA=s introducing and carrying dealer models are examples of regulatory responses to this desire for change.

The use of non-traditional structures is driven by business concerns, including competitive pressures and the desire to reduce costs. These structures have arisen in the mutual fund industry due, in part, to the historic relationship between insurance sales and mutual fund sales. Many mutual fund salespersons began as insurance salespersons who subsequently became registered to sell mutual funds. Insurance products were sold through the registrant=s own corporation, and, due to dual licensing, the registrant found it desirable to also conduct the sale of mutual fund securities through this corporation. Tax savings, business expansion without large additional costs, and the desire of individuals to have their own business are often cited as reasons for the use of non-traditional structures.

Principles for Distribution of Securities

The Committee determined that the following principles must be adhered to in any regime of permissible distribution structures:

(a) **Legal responsibility**: the dealer must be liable to the clients and to securities regulators for all financial service activities of its salespersons

that are not subject to another regulatory regime.

(b) **Bonding**: The bonding and insurance carried by the dealer must cover the activities of the dealer=s salespersons regardless of the relationships that exist between the dealer and the salespersons.

(c) **Supervision**: appropriate supervision is required to ensure that salespersons= dealings with clients comply with securities legislation and requirements. The supervisor must have the ability, and the authority, to carry out his supervisory function.

(d) **Client awareness**: clients should be able to identify easily the dealer with which they are dealing and the types of investor protection that are available to the clients.

(e) **Conflicts**: before entering into a transaction, clients should be aware of the compensation arrangements and any relationships that exist between the registrant and any other party that may affect the advice given.

(f) **Competence**: a dealer is responsible for ensuring its staff maintains an appropriate level of competence.

(g) **Oversight**: regulators must ensure that they are able to carry out their oversight responsibilities in accordance with their respective legislation. The Committee places great value on the transparency of an organization. In the absence of demonstrated advantages to clients, the Committee will reject structures that are more complex and therefore less easily monitored than the traditional distribution structure.

(h) **Market structure**: securities legislation and requirements must not be a barrier to market competition and development where no regulatory concern has been identified.

Short term goals

The Committee has identified certain principles that are fundamental to its deliberations and to the formulation of its positions. Ensuring adherence to these principles is the short term goal of the Committee. The principles are:

(a) all financial service activities, that are not subject to another regulatory regime, that are pursued by a dealer=s salespersons must be conducted through the dealer;

(b) the dealer must be liable for all financial service activities, that are not subject to another regulatory regime, conducted by its salespersons; and

(c) regardless of the nature of the relationsh ip that exists between the salesperson and the dealer, the books and records of the dealer and all salespersons that relate to financial activities, not subject to another regulatory regime that the salesperson conducts must be available for inspection at all times by the dealer and regulators.

The Committee believes that these principles are fundamental components of investor protection. Without these requirements the client may be misled as to the entity with which she is dealing. The client may not have access to the dealer=s bonding and regulatory capital in the event of a compensable loss, and the duty of the dealer and the salesperson to ensure suitability may not be properly executed.

Long Term Goals

The Committee has concluded that the following are appropriate long term goals that are to be achieved in consultation with other regulators:

(a) all financial service activities conducted by a dealer=s salespersons must be conducted through, and appear on the books of, an appropriately registered or licensed and acceptable entity; and

(b) the dealer must be liable for all financial service activities between the dealer=s salespersons and it clients. Towards this end the Committee is recommending the imposition of enhanced, statutory liability on dealers. This subject is discussed under Position #6 below.

The ultimate objective is to achieve uniform levels of investor protection through

regulation of financial services, regardless of the regulatory regime through which the services are delivered. For example, uniform levels of regulation of financial planning would be required under both the insurance and securities regulatory regimes.

Discussion and Positions

The Committee was asked to review six specific subjects. Those subjects are: dual employment, securities sold under exemptions, trade names, referral arrangements and commission splitting, financial planning activities by registrants, and the legal relationships that exist between dealers and their salespersons. The following is the Committee=s discussion of those subjects in the context of the principles enumerated above and the Committee=s regulatory responses.
The Committee intends that the positions in this Position Paper are to be interpreted as minimum standards. SROs and regulators charged with implementation may choose to supplement them.

Dual Employment

Many salespersons are employed by more than one entity and pursue more than one line of business. For example, they may be employed as insurance agents and as mutual fund salespersons. The CSA=s APrinciples of Regulation@ specify certain rules that apply to dual employment by mutual fund salespersons who are employed by financial institutions. Further, most jurisdictions have rules that preclude, with some exceptions, dual employment. Accordingly, employment in more than one financial capacity may be restricted. The Committee is advised that persons who are dually employed frequently style themselves as Aindependent contractors@.

The Committee identified the following regulatory concerns that arise from this situation:

(a) legal responsibility and liability for the acts of salespersons may not be clearly defined;

(b) clients may be confused as to the entity they are dealing with;

(c) conflicts of interest may exist that are not fully disclosed to the client;

(d) the books and records of the salesperson=s operation may not be readily accessible for review by the dealer or regulator;

(e) the dealer=s ability to supervise a salesperson=s registerable activities adequately may be compromised unless the dealer can supervise all of the financial service activities of the salespersons that are not subject to another regulatory regime; and

(f) part-time salespersons may not be able to maintain their proficiency at as high a level as is required to ensure the proper performance of their duties.

The Committee is supportive of continuing education programs for all salespersons to ensure that their level of proficiency and competence is maintained.
Position #1

Dual employment should be allowed, provided that the salespersons= other employment or other activities do not interfere with their duties and responsibilities as salespersons [3] and provided that the dealer is responsible and liable for all of the financial service activities of the salespersons that are not subject to another regulatory regime. [4]

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[3] In Québec, the introduction of the new regulatory regime in Bill 188, *An Act respecting the distribution of financial products and services,* may give registered firms the capacity to conduct mutual fund sales, life insurance sales and financial planning activities. Bill 188 activities must be conducted through the dealer (the firm). With the implementation of Bill 188, a representative would be allowed to perform different activities through different firms. Firms will be liable only for the activities performed through it. The books and records of a specific firm will contain transactions related only to a specific activity of its representative. Mutual fund activities should be performed under only one firm. But other financial activities can be performed by a representative through different firms. Supervision of all firms in the financial activities prescribed by Bill 188 will be performed by the Bureau des services financiers (ABSF@).

The activities pursued by the representative that are governed by Bill 188 must be the representative=s principal activity. Non-financial activities may be performed if, as provided in the regulations under Bill 188, those activities are not incompatible with the duties imposed on the representative by Bill 188.

[4] In Québec, with respect to Bill 188 activities, dealers and their

Implementation of this position would require the adoption of regulations to ensure that:

(a) the dealer supervises all financial service activities, that are not subject to another regulatory regime, carried on by its salespersons;

(b) salespersons may not receive revenue from financial service activities that are not subject to another regulatory regime, except through the dealer;

(c) all financial services, that are not subject to another regulatory regime, must be performed on behalf of and through the dealer. The dealer must be aware of and give prior approval for all such activities carried on by each of its salespersons;

(d) conflicts of interest that arise due to dual employment are disclosed to the client prior to the execution of any transactions;

(e) the full legal name of the dealer is disclosed in all dealings between the salesperson and clients; and

(f) the dealer and regulators have access to all books and records regarding the salesperson's financial service activities.

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representatives, financial planners, insurance agents, and brokers will be supervised by the BSF. Further, restricted dealers and their representatives must disclose their registration category along with the full name of the dealer in all communications with clients.

Securities Sold Under Exemptions

The Committee is advised that many mutual fund dealers sell securities under exemptions to clients who normally invest in mutual funds, clients who may not be familiar with the characteristics of these other products. These products sold under exemptions include, for example, limited partnership units sold under the seed capital or sophisticated investor exemptions. The Committee understands that salespersons often sell these investments Aaway@ from the dealer, and the transactions do not appear on the books of the dealer.

Regulatory concerns

The Committee has identified the following as regulatory concerns that arise from this practice:

(a) salespersons with restricted registrations are frequently selling exempt securities through distribution channels that normally attract clients seeking relatively safe investments where those safe investments are subject to a comprehensive regulatory regime;

(b) the proficiency of the salesperson that is advising on the exempt securities may not be adequate in circumstances where the clients, due to previous dealings with the salesperson and the salesperson=s registration, are expecting a higher level of proficiency than they would from a stranger;

(c) clients may be confused about whom they are dealing with;

(d) there may be no access to the books and records that relate to sales that are not made on the books of the dealer or there may be no records at all of the sales;

(e) the dealer may not be able to supervise the salesperson effectively;

(f) the ability of regulators to perform effective oversight may be impaired; and

(g) the liability of the dealer for the acts of the salesperson may not be certain.

Position #2

Restricted dealers and salespersons will be permitted to sell only those securities for which they are expressly registered, deposit instruments and government debt instruments.[5, 6]

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[5] Exempt securities in Québec are deposits and government debt instruments. The distribution of those securities is, amongst other things, part of an insurance agent=s function, and the distribution of the products, record keeping, and supervision will be performed by the firm that is responsible for the insurance activities of the representative. In the case of an independent representative, the supervision will be performed by the BSF.

[6] In Saskatchewan, agents who sell guaranteed investment certificates (AGICs@)are subject to reporting requirements and to business practice rules.

Restricted dealers that wish to sell other exempt securities [7] may apply to the appropriate securities regulatory authority for permission to do so. Some securities regulatory authorities may require a separate application for each offering the restricted dealer wishes to sell. Other securities regulatory authorities will consider the matter when imposing conditions on the dealer=s registration. It may also be that some securities regulatory authorities will not be prepared to grant this relief.

Trade Names

Trade names are used within the securities industry in a number of ways. Some dealers operate under names that are different from the name of the registered corporation, while some salespersons use trade names associated with their own business and not with the dealer=s corporate or trade name. The Committee understands that these salespersons often conduct their registerable activities through the dealer, while other financial service activities are conducted through the salesperson=s company. The Committee also understands that several businesses may share a common trade name.

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[7] In Ontario, GICs are not securities. However, limited market dealers (ALMDs@) that are licensed to sell only NP 39 mutual funds pursuant to NP 36 simplified prospectuses cannot, without express permission, sell GICs. It follows that in Ontario, notwithstanding the status of GICs, the Committee=s position on securities sold under exemptions will apply to LMDs whose registration is restricted to the sale of NP 39 mutual funds.

In the Committee=s view, the proper use of trade names could, in fact, remove some potential for client confusion. Proper use is to be guided, in part, by the principle that all trade names are to be registered[8] to the dealer where those trade names are used in the conduct of activities related to trading or advising on securities and financial service activities that are not subject to another regulatory regime.[9] The trade name may be used by the dealer=s salespersons as long as the dealer=s name is also disclosed to the clients.[10]

It has been suggested that a contractual relationship could be created between the dealer and its representatives regarding the use of a trade name belonging to the salespersons. Such a contractual relationship would, it is suggested, provide the client with an adequate level of protection. The Committee rejects any suggestion that relationships that are created by laws of general application can be re-created through the use of contractual relationships between the dealer and its salespersons. On this specific issue, the Committee points out that rules of privity of contract will not permit a stranger to the contract to enforce its provisions, even where those provisions are for the benefit of that stranger. Laws of general application, on the other hand, do grant

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[8] By Aregistered@ the Committee intends that the trade name be registered for purposes of the general law of the relevant jurisdiction. For example, in some jurisdictions this involves filing of a declaration of trade name with the appropriate authority.

[9] The Committee=s position will not require the registration, *etc.* of trade or corporate names used by registrants to conduct financial services that are subject to another regulatory regime. For instance, where a registrant is dually licensed to sell insurance products and does so through his own corporation, that corporation=s name will not be affected by this requirement as long as the registrant does not conduct registerable activities, or financial services not subject to another regulatory regime, through that corporation.

[10] The CVMQ requires restricted dealers and their representatives to disclose their registration category along with the dealer=s full legal name. Trade names must also comply with the *Regulation respecting titles similar to the title of a Financial Planner*. In British Columbia, the dealer=s name, as registered, must be at least equal in size and prominence as any trade name or trademark used in communications with the public.

standing to parties that are harmed by the actions of persons using a trade name to seek compensation from the registered user of the trade name.

Regulatory concerns

The Committee has identified the following as regulatory concerns that arise from these practices:

(a) the dealer may not be legally responsible for all financial service activities carried on by the salesperson under a trade name not registered to the dealer; and

(b) clients may be confused about which entity they are dealing with.

Position #3

Trade names and trademarks will be permitted to accompany, but not replace, the full legal name of the dealer on materials that are used to communicate with the public, provided that the following conditions are met: [11]

(a) all trade names and trademarks, through which a salesperson conducts activities related to trading or advising on securities and financial service activities that are not subject to another regulatory regime, are registered to the dealer;

(b) each dealer is aware of and gives prior approval to the trade names and trademarks that are used by any of its salespersons for the conduct of financial service activities that are not subject to another regulatory regime;

(c) the dealer gives notification to and receives approval from the relevant securities regulatory authorities of every trade name and trademark registered to it prior to its use. The relevant securities regulatory authority must also approve any transfer of trade names or trademarks prior to their use by the transferee dealer;

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[11] In Québec, under Bill 188, representatives will not be permitted to use trade names or trademarks.

(d) a trade name can be used by only one dealer at a time, although this principle may have to be altered in the context of the introducing and carrying dealer model; and

(e) all written agreements with clients are entered into in the dealer=s full legal name.

Referral Arrangements and Commission Splitting

A referral arrangement is an agreement whereby a registrant earns or pays a fee for the referral of a client to or from a non-registered party or a party registered in a different category. The fee may be a flat fee; it may be contingent and based on commissions or fees earned; it may be based on the value of assets transferred. The Committee does not distinguish between referral fees that are based on a flat fee and those based on commissions (fees based on commissions are sometimes referred to as Acommission splitting@). The Committee does not believe that the manner by which the quantum of the fee is calculated raises any incremental regulatory concerns. It will be up to those who seek to take advantage of an acceptable referral fee arrangement to ensure that the activities of the party making the referral do not constitute acts in furtherance of a trade in securities or advising on securities. The Committee has excluded from its definition of referral arrangements any arrangement whereby payment based on the level of sales is made to a third party service provider where the services provided are clearly administrative and the service provider has no direct contact with clients or their assets. Arrangements of this type and the regulatory concerns they raise are dealt with below under the discussion of the service provider business structures.

Regulatory concerns

The Committee is concerned about the following regulatory issues:

(a) persons that lack the appropriate proficiency or registration may be acting in furtherance of trades in securities or may be giving advice regarding securities;

(b) conflicts of interest may not be disclosed adequately to clients prior to entering into transactions; and

(c) clients may be confused as to the entity with which they are dealing.

The Committee is concerned that referral fee arrangements are unregulated in many jurisdictions. The Committee believes that some arrangements may be acceptable, but that the arrangements will require monitoring and supervision to address the Committee=s concerns. Clients may not know who is responsible for certain registerable activities. Disclosure of the fee and the identity of the recipient will assist in this regard. This disclosure will also be effective in bringing potential conflicts of interest to the attention of the client. Disclosure will not, however, alleviate the concern about parties without the appropriate registration or proficiency acting in furtherance of trades in securities or giving advice regarding securities.

Position #4

Referral arrangements will be permitted only between dealers or between dealers and entities that are licensed or registered under some other regulatory system that is acceptable for the purpose of referral fee arrangements (Aacceptable entity@).[12] For these purposes Canadian financial institutions,[13] insurance agents, insurance brokers and, in Québec, mortgage brokers, real estate brokers and financial planners, are acceptable. Therefore, referral arrangements will be allowed, provided that:[14]

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[12] In this position, Aacceptable entity@ means an entity that is regulated in the

context of financial regulation. It does not include, for example, lawyers or accountants.

[13] National Instrument 14-101 Definitions s.1.1(3):

> ACanadian financial institution@ means a bank, loan corporation, trust company, insurance company, treasury branch, credit union or caisse populaire that, in each case, is authorized to carry on business in Canada or a jurisdiction, or the Confédération des caisses populaires et d=économie Desjardins du Québec

[14] In Québec, registrants are not permitted to enter into referral fee arrangements with unregulated entities. All agreements must be filed with the CVMQ. The first agreement is approved by the CVMQ, and all subsequent agreements, that are the same as the first, need only be filed. At the time of writing, the regulations that will govern these activities under Bill 188 have not been drafted.

(a) there is a written agreement governing the payment of referral fees between the dealers, or the dealer and the acceptable entity, and not between the salespersons themselves. The written agreement must be filed with the relevant securities regulatory authority. The agreement must describe the means by which the dealer will ensure compliance with applicable securities regulation, and the agreement must be filed prior to the execution of the first transaction that will lead to the payment or the receipt of fees as provided for in the agreement;

(b) all fees received are paid to the dealer by the other dealer or the acceptable entity named in the agreement, and the receipt of the fees is recorded on the books of the dealer;

(c) all fees paid are paid by the dealer to the other dealer or acceptable entity, and the payment of those fees is recorded on the books of the dealer;

(d) written disclosure is made to clients of any referral fees prior to a transaction taking place. This disclosure must include the amount or means by which the fee is calculated, the reason for the payment, the name of the party to or from whom the fee will be paid or received, and a statement that it is illegal for the recipient of the fee to give advice regarding a transaction if he is not licensed or registered to give that advice;

(e) a signed acknowledgement of consent is obtained from each client regarding the above disclosure prior to the execution of the first transaction that will lead to the payment or the receipt of fees as provided for in the agreement; and

(f) the party receiving the fee is not engaged in trading or advising activities that it is not licensed or registered to perform.

Financial Planning Activities by Registrants

Financial planning and its regulation are attracting a great deal of attention. Participants in the securities industry and other financial industries often offer financial planning services, whether for a fee or not, as an adjunct to the other services they

offer. There are several organizations that provide training and certification for financial planners. In Québec, the CVMQ regulates registrants acting as financial planners. When it comes into force, Bill 188 will regulate financial planning activities. However, in the other jurisdictions there is a lack of consistency in the proficiency requirements and attributes of people who act as financial planners.

The CSA[15] have undertaken an initiative on financial planning. Staff are looking specifically at the regulation of financial planning and, generally, at advising on securities. The Distribution Structures Committee will, to the extent possible, rely on the work that is being done in this area by the committee on the regulation of financial planning. The Distribution Structures Committee=s concern is that activities that may lead to a trade in securities, or that involve advice on securities, should be regulated.

The Committee=s regulatory concerns and the general framework for dealing with these concerns are discussed below. These concerns and the Committee=s positions were considered only in the context of registrants provide that provide financial planning services. The Committee has not looked at these issues in relation to financial planners that are not registered under the securities regulatory regime.

Regulatory concerns

The Committee identified the following as regulatory concerns in CSA jurisdictions other than Québec, where these concerns have been addressed by regulation: [16]

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15 Québec has established a regulatory regime for financial planners. Accordingly, this initiative is being conducted without the participation of the CVMQ.

16 In Québec, financial planning activities will be performed by a representative through the appropriately registered firm. These financial planning activities will be regulated by the BSF, which will, for mutual funds, insurance, and financial planning, act as an SRO.

(a) the lack of minimum proficiency requirements for persons providing financial planning services;

(b) the confusion of clients as to who is providing the service;

(c) the uncertainty as to who is responsible for the advice that is given ;

(d) the risks to dealers whose salespersons are providing financial planning services where there is no supervision or errors and omissions insurance in place; and

(e) the conflicts of interest that may exist when financial planners earn their income from the subsequent sale of products.

The large number of financial planning designations that have been established leaves the consumer in the position that she must make her own judgement as to whether or not the individual offering the advice is qualified. Consumers may have a great deal of difficulty making an appropriate decision. Codifying proficiency standards and limiting the ability of organizations to grant certifications or charters is a way to reduce the magnitude of this problem.

The Committee is also concerned that the advice received by investors will not be free of influence from conflicts of interest. Disclosure of compensation for product sales would assist consumers in determining the value of the advice they have been given.

The Committee is advised that salespersons often conduct their financial planning activities through companies other than the dealer that sponsors the salespersons' securities registration. Clients may not understand that the service is not being offered by the dealer or that the dealer may not be liable for any losses that result from following the advice given. This situation leads to concerns about the lack of dealer supervision of the salesperson=s financial planning activities, the risks faced by dealers who are not insured for this activity, and the conflicts of interest that may arise.

Position #5

Salespersons who provide financial planning services, must provide these services through the dealer that sponsors their securities registrations. The Committee is supportive of all dealers having comprehensive errors and omissions insurance coverage. In addition, a salesperson who provides financial planning services must meet the following requirements:

(a) the salesperson must satisfy minimum proficiency requirements that are set for registrants who provide financial planning services;

(b) the salesperson must deliver a disclosure statement to the client that informs the client of the means by which the salesperson generates his income; that informs the client that the client need not implement the plan through the financial planner that prepared it, that is, at the option of the client, the plan can be executed through any appropriately registered entity; that informs the client of the fact that commissions are received for transactions to implement the plan; and that advises the client of the various licenses and registrations held by the salesperson, including those for securities, insurance, and real estate;

(c) the disclosure document described above is filed with the relevant securities regulatory authorities;

(d) all fees earned from financial planning activities are to be paid to and recorded on the books of the dealer;

(e) the financial planning activities conducted by the salesperson are subjected to the same level of supervision by the dealer as are securities transactions;[17] and

(f) an adequate level of insurance is in place.

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[17] The Committee recognizes and accepts that supervision of financial planning activities will involve processes that are different from those involved in supervising securities trading. However, the Committee expects that dealers will achieve the same level of supervision, through the adoption of appropriate processes. In particular, the Committee contends that supervision must include the review of financial plans by persons who are qualified to perform financial planning activities.

Legal Relationships and Business Structures

The Committee analysed the following legal relationships that may exist between a dealer and its salespersons:

Dealer	**Salesperson**
Employer	Employee
Principal	Agent
Independent Contractor	Independent Contractor

In addition to these relationships, the Committee considered the regulatory issues that arise when corporations enter into relationships with the dealer. The Committee=s conclusions regarding the acceptability of these relationships are discussed in this section.

(a) *Dealer as employer and salesperson as employee*

The existing regulatory system is premised on the existence of an employer and employee relationship between a dealer and its salespersons. Therefore, a relationship between a dealer and its salespersons that is properly characterized as employer and employee is acceptable to the Committee.

Regulatory Concerns

Committee members have expressed concern, however, over whether even the traditional employer and employee relationship provides sufficiently comprehensive protection for investors. This concern arises from the fact that salespersons may offer services, such as financial planning, or they may sell products, such as securities sold under exemptions, which the dealer does not consider to be part of its business. It is not clear in these situations whether the dealer would be held liable for compensable losses suffered by clients as a result of these activities, despite the employer and employee relationship. Further, even with the requirements of Position #1 fully satisfied so that all financial service activities of salespersons are conducted through the dealer, where a salesperson causes a client loss, the courts may find that the dealer is not liable if the salesperson was acting on a Afrolic of her own@. The Committee believes that adequate supervision and internal controls at the dealer level

would reduce the potential for such losses to occur and that failure to meet this regulatory standard ought to give rise to liability to clients. Concerns about supervision and internal controls are considered in the discussions on other business structures that follow.

Position #6

The Committee believes that the best long term approach to ensure comprehensive investor protection is to amend legislation to impose statutory civil liability on dealers for all the financial service activities of their salespersons, regardless of the business structure used to deliver those services. This position is intended to prevent dealers from avoiding liability by defining the scope of the representative=s employment so narrowly that it does not include the activity that caused the client losses. [18]

[18] See for example: *Druiven* v. *Warrington* [1998] O.J. No. 679 (Ont. Ct. Gen. Div.) This case raises uncertainties as to the extent that a client will be protected by a dealer=s vicarious liability for the actions of its salespersons.

In Québec, Bill 188 creates a connection of responsibility between the firm (the dealer) and its representatives, whatever the relationship that exists between the representative and the firm. Bill 188, section 80 makes the firm responsible for any loss suffered by the client due to the fault of the firm=s representative in the performance of his functions. The representative=s function is not linked to the nature of the relationship that exists between the representative and the firm.

(b) Dealer as principal and salesperson as agent

Many dealers and their salespersons have entered into arrangements that characterize the salespersons as independent contractors. Despite this characterization, the Committee is of the view that many of these relationships are more likely, in law, that of principal and agent. The Committee also notes that, when examined closely, many relationships between dealers and their salespersons that are characterized as that of principal and agent are, in substance, that of employer and employee. The dealer=s liability depends upon the legal relationship which exists between the dealer and the salesperson, and it is, therefore, important to characterize those relationships properly.

In the relationship of principal and agent, a salesperson operates with a very high degree of autonomy. Salespersons that conduct business as agents do so in an effort to achieve tax advantages while dealers use this relationship, for example, to expand their businesses without incurring increased salary costs. The salesperson can, and does, bind the dealer in contracts for the sale of securities. The dealer, as principal, is liable for the acts and torts committed by the salesperson, as agent, in the course of the business the agent was authorized, or was held out by the principal as authorized, to conduct.

Regulatory concerns

The Committee believes that the following regulatory concerns arise from the legal relationship of principal and agent:

(a) the dealer=s ability to supervise its salespersons properly may be compromised;

(b) the ability of regulators to perform effective oversight may be compromised;

(c) access to books and records of the salesperson by the dealer and regulators may be impeded; and

(d) issues may arise concerning bonding and insurance coverage of agents. [19]

[19] In Québec, Bill 188 requires that, when registe ring, the firms must demonstrate that every non-employee representative acting on its behalf has liability insurance that satisfies the requirements of the regulations made under Bill 188.

The Committee has concerns about the ability of the dealer to supervise effectively salespersons who are agents and not employees and about the dealer=s ability to maintain the level of control over the activities of the agent that is required under securities legislation. Supervision of an agent is more difficult because of the autonomy that is inherent in the relationship. It follows that the oversight role of regulators is also made more difficult.

The Committee is concerned as to whether or not the agent will maintain adequate books and records and whether the dealer will have sufficient proprietary interest in those books and records to ensure that it can, in the event of disputes, obtain access to them. The dealer and regulators must have access to those books and records at all times.

The Committee also wants to ensure that the protections offered under the minimum bonding or insurance coverage required to be maintained by dealers on behalf of their salespersons do, in fact, cover agents.

It should be noted that in some jurisdictions legislation requires that a salesperson must be an employee of the dealer. Where this is the case, the Committee is of the opinion that, from a policy point of view, relationships characterized as that of principal and agent may nonetheless be acceptable if, through the adoption of the conditions listed below, they approximate to a high degree the relationship of employer and employee. Prior to implementation, however, those jurisdictions will require legislative amendments to permit salespersons to operate as agents of the dealer.

Position #7

The Committee believes that a relationship between dealer and salesperson that is characterized as that of principal and agent may be structured in such a manner as to replicate the attributes of liability, supervision, *etc.,* that exist in the relationship of employer and employee. A principal and agent relationship between a dealer and a salesperson is, therefore, acceptable provided that the following conditions are met:

(a) the dealer is responsible for and supervises all of the activities of its salespersons that relate to the delivery of financial services and products to its clients, other than financial service activities subject to another regulatory regime;

(b) the liability of a dealer to clients for acts of the salesperson is the same as

that which would apply in an employer and employee relationship. This liability may be reinforced through the use of appropriate conditions of registration;

(c) insurance policies are in place that ensure adequate coverage of agents; and

(d) the salespersons maintain appropriate books and records to which the dealer and regulators have access even in the event of disputes between the dealer and the salespersons.

(c) Salesperson acting as independent contractor

The Committee is concerned about the existence today of relationships between dealers and their salespersons that are characterized as that of independent contractor. Whether or not these relationships are such at law, there is little question that their existence has the potential to erode investor protection because the relationships are used, in part, to restrict the circumstances in which the dealer will be liable for the actions of its salespersons. The discussion in this section concerns those relationships in which the salesperson is a true independent contractor. [20]

True independent contractors represent a low level of risk to dealers and a high level of risk to investors. True vicarious liability does not exist. In the context of trading in securities, an independent contractor cannot bind the dealer to a contract with a third party. The structures that the Committee considers acceptable are those which contain a legal relationship between the dealer and the salesperson that provides for an appropriate level of liability on the part of the dealer for the actions of the salesperson. The Committee is of the opinion that the relationship of independent contractor does not provide an appropriate level of liability.

Regulatory concerns

The Committee has the following concerns about this relationship:

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[20] Independence of action is, perhaps, the most striking attribute that distinguishes between the relationship of independent contractor and that of principal and agent. An independent contractor works in accordance with his own methods. The principal does not control these methods. This is not, however, the only distinguishing feature of an independent contractor.

(a) the reduced scope of liability imposed on the dealer for the actions of independent contractors;

(b) the possible impairment of the dealer=s ability to supervise the independent contractors effectively;

(c) the ability of regulators to perform effective oversight may be impaired;

(d) the possible impairment of the dealer=s and regulator=s ability to access the books and records of the independent contractor; and

(e) the dealer=s bonding and insurance coverage may not extend to independent contractors.

Position #8

Salespersons will not be permitted to carry out their financial service activities on behalf of a dealer where the relationship between the dealer and the salesperson is that of an independent contractor.[21]

(d) Incorporation without registration

The Committee is aware of the existence today of non-registered corporations which provide services to dealers and their salespersons and which receive commissions from the sale of securities. These corporations are not registered with the relevant securities authorities and, as a consequence, are prohibited from carrying on the business of selling or advising in securities. The Committee refers to these types of situations as multi-level selling structures.

For example, a salesperson may establish a personal corporation and direct that

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[21] In Québec, under section 13 of Bill 188, securities representatives are not permitted to pursue their activities as an independent representatives, or partners or employees of an independent partnership. Securities representatives must act for a registered firm; financial planners and insurance agents may act for a registered firm or as an independent representative or as a partner or employee of an independent partnership.

commissions earned by the salesperson from the sale of securities be paid to that corporation. The salesperson may also conduct other activities, such as the sale of insurance products and financial planning activities, through the corporation. The insertion of the salesperson=s corporation into the business structure may lead to beneficial tax rates, but it may also limit the salesperson=s personal liability.

In other cases, the non-registered corporation has the responsibility of running a branch of a dealer, and it may employ one or more salespersons sponsored by the same dealer. The payment of commissions earned by each salesperson operating out of the branch is often directed to the corporation. The corporation retains some portion to cover branch expenses and remits the balance to the salesperson. In other cases each salesperson receives the commission directly from the dealer and then pays a portion to the corporation to cover overhead costs. Normally, one of the owners of the corporation is appointed as branch manager and, as such, is responsible for approving new accounts and the supervision of trades. The salespersons employed by the branch may not have an employment relationship with the dealer, notwithstanding that because they are registered as salespersons of the dealer they must trade on behalf of the dealer. In addition, the salespersons operating out of these branches may themselves incorporate and receive their commissions through their own personal corporations.

In still other cases, these corporations have entered into franchise arrangements in which the dealer, as franchiser, grants certain rights and entitlements to one or more salespersons to operate a business as franchisee in connection with the commercial provision of securities trading and advising services pursuant to the dealer=s registration. The franchisee is not registered as a dealer and operates a branch in a manner similar to that described above.

Regulatory concerns

The Committee is concerned about the following issues arising from the insertion of a salesperson=s non-registered corporation between the dealer and the salesperson:

(a) the non-registered corporation may be performing acts in furtherance of trades in securities or may be giving advice regarding securities; [22]

[22] In Québec, the receipt of commissions is considered conclusive evidence that the person receiving the commission has been performing acts in furtherance of trades in securities.

(b) investor protection may be reduced if a salesperson=s personal liability for client losses is limited by the insertion of a non-registered corporation;

(c) clients may be confused about the identity of the entity with which they are dealing and who is responsible for the advice they are receiving, particularly if salespersons provide other services or sell other products through a non-registered corporation and not through the dealer;

(d) dealers may attempt to avoid liability for client losses on the basis that the client only has a legal relationship with the non-registered corporation;

(e) the dealer=s ability to supervise a multi-level selling structure effectively may not be adequate;

(f) the ability of regulators to perform effective oversight of activities in a multi-level selling structure may be impaired; and

(g) access by the dealer and regulators to the books and records of non-registered corporations may be impaired.

Position #9

Subject to the discussion that follows concerning introducing and carrying dealer structures and service provider structures, [23] and in the absence of legislation that allows a salesperson to render registerable services through a corporation while preserving that salesperson=s, and the dealer=s, liability to clients for the salesperson=s actions, salespersons will not be allowed to incorporate in order to conduct registerable activities and financial service activities that are not subject to another regulatory regime.

Proposed Business Structures

The Committee prepared an analysis of three business structures that the Committee considers acceptable for use as distribution structures in the securities industry:

(a) dealer as employer and salesperson as employee, or dealer as principal

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[23] In Québec, the possibility of creating new categories of registrants is not reflected in Bill 188.

and salesperson as agent;

(b) the service provider business structure; and

(c) the introducing and carrying dealer model.

These business structures are illustrated in the diagrams that are attached as Appendix AA@ to this Position Paper. These business structures could be used either in isolation or in combination to create acceptable business arrangements.

The Committee considers it important to remind readers of the very significant differences between dealers and registered representatives. All entities performing acts in furtherance of a trade in securities or advising in regard to securities must be registered. To be registered, representatives must be employed by a registered dealer, and only registered dealers can employ representatives. Only individuals can be registered as salespersons, and representatives cannot employ other representatives. It follows that any entity that purports to employ representatives must be registered as a dealer. Registration as a dealer entails satisfaction of all the capital, supervisory, and other requirements of a dealer. The Committee is, therefore, of the opinion that, for example, any business structure wherein representatives purport to conduct registerable activities through unregistered corporations is contrary to the provisions of securities legislation. Neither salespersons nor dealers can deliver registerable services through unregistered entities.

(a) Dealer as employer and salesperson as employee, or dealer as principal and salesperson as agent

The first diagram portrays a business structure involving one corporation which is registered in a dealer category. It includes more than the traditional relationship of employer and employee as it contemplates salespersons functioning as agents as an alternative to salespersons being employees of the dealer.

Where the dealer is the employer and the sales force is composed of employees, this structure is acceptable. Where the dealer is the principal, and the sales force consists of agents, the structure will be acceptable only as long as the conditions set out in Position #7 are satisfied.

(b) The service provider business structure

The second diagram portrays a service provider relationship. The structure assumes that an acceptable relationship exists between the dealer and its salespersons. In the service provider relationship, an arrangement exists whereby the dealer contracts some of its non-trading functions to a separate, non-registered corporation which charges a fee to perform those functions. The services provided by the non-registered corporation must be limited to those which do not raise regulatory concerns. The non-registered corporation will not be permitted to provide back office services which have a direct impact on client assets. Permitted services are those that are clearly administrative, such as the provision of premises, computers, phones, and so on. The payments directed to these entities from the dealer, or salespersons, are directly related to the services provided. The Committee believes that there are regulatory concerns associated with the provision of services by a non-registered corporation, such as:

(a) attempts may be made to transfer dealer liability to the service provider;

(b) attempts may be made to transfer the performance of supervision duties away from the officers and employees of an appropriately registered entity;

(c) bonding issues may arise when responsibility for certain functions is transferred from the dealer to the service provider;

(d) where the service provider provides service s to more than one dealer, concerns may arise over the commingling of funds; and

(e) the dealer=s and regulator=s access to all books and records maintained by the service provider may be impaired.

Position #10

Unregistered corporations may provide certain services to a dealer and its salespersons, provided that:

(a) the dealer=s ultimate responsibility and liability to clients is not affected by these arrangements;

(b) the dealer is prohibited from contracting out supervision of trading and other compliance functions to any service providers; [24]

[24] It has been suggested that compliance can be contracted out. The

(c) commissions earned for the performance of registerable activities or financial services not subject to another regulatory regime must be paid directly to the salesperson; commissions cannot be paid to the salesperson through a service provider;

(d) the dealer must disclose in its application for registration which services are being contracted out and to whom;

(e) the dealer must file any new arrangements, or changes to existing arrangements, with the securities regulatory authorities; and

(f) for the purposes of carrying out their supervisory obligations, the dealer and regulator must at all times have access to the premises from which salespersons operate.

(c) The introducing and carrying dealer model

The third diagram presents an introducing and carrying dealer business structure. It is based on structures that are available under SRO introducing and carrying dealer rules. Both the introducing dealer and carrying dealer are registered as dealers. The Committee encourages the SROs to continue developing new variants of the introducing and carrying dealer models.

Committee rejects this suggestion. The Committee views the compliance function as integral to the daily operations of a dealer. The introducing and carrying model disclosed below may require amelioration of this prohibition, but this would occur only in circumstances where the CSA is satisfied that the proposed compliance regime is appropriate.

According to the IDA=s Compliance Interpretation Bulletin C-111, AIntroducing and Carrying Broker Arrangements@, the purpose of the introducing and carrying arrangement is to allow a member of an SRO to utilize the back office facilities of another SRO member. The services provided by the carrier may include order execution, clearing and settlement, custody of funds and securities, and maintenance of books and records. The arrangement allows the introducing dealer to rationalize its own operations while retaining its trading relationship with customers.

The Committee is aware of the existence of non-registered corporations that do not limit the services provided to dealers and their salespersons to those considered acceptable by the Committee, as described under the service provider business structure. As stated in Position #9, the Committee believes these structures are unacceptable. However, with all participants belonging to a fully operational SRO, such structures might be permissible provided that the previously non-registered corporation becomes registered as an introducing dealer with the SRO. In the interim, however, the Committee doubts that any amount of regulation, no matter how intricate, can overcome the added risks and impediments to supervision and dealer liability presented by these structures.

Position #11

Dealers may only enter into arrangements involving multiple corporations when all those corporations are registered in an appropriate category of dealer or the arrangement is in accordance with the service provider model.

Implementation

The Committee has stated a large number of positions as a means of achieving its short and long term goals. Some can be implemented by policy, others by rule, and others will require legislative amendments. Much of the detail will be left to the SROs to determine and implement by way of SRO by-laws or regulations. It is clear that the positions may have a significant impact on the manner in which registrants organize and conduct their business operations. The Committee believes that its concerns are well founded, and its positions flow from those concerns.