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MEMBER REGULATION NOTICE

STEALTH ADVISING

This Notice clarifies the position of MFDA staff with respect to advice and other securities related services provided by non-registered individuals to clients of MFDA Members.

Background

MFDA staff has become aware of situations where non-registered individuals have engaged in securities related business through various arrangements with Approved Persons of MFDA Member firms. Under such arrangements, client accounts are set up at the Member with the registered Approved Person as the representative of record, and trading activity is processed using the Approved Person's representative code. However, a non-registered individual services the account and this individual provides advice and makes recommendations to clients with respect to securities in the account, directing the registered Approved Person to place trades. The arrangements between the non-registered individual and the Approved Person are structured so that the non-registered individual receives compensation, often a portion of the commissions paid to the Approved Person by the Member. The compensation may be paid directly or through the division of revenue to the branch operating company, or through inflated rent or management fees. Essentially, the non-registered individual maintains a book of business without registration, by executing trades through a registrant. This is done without notice to, or approval of the Member.

The non-registered individual involved in the arrangements may have been terminated by or resigned from a Member or may never have been registered. The individual may also conduct other business with the clients, such as insurance, at offices that are shared with Approved Persons of the Member. This may add to client confusion with respect to the registration status of the non-registered individual.

Regulatory Concerns

These situations raise several significant regulatory concerns. Individuals in the above scenarios are providing advice with respect to trades in securities without registration with the appropriate securities regulatory authorities. In addition, such arrangements also fail to satisfy the MFDA Rules regarding the conduct of securities related business on behalf of an MFDA Member firm. Under MFDA Rule 1.1.1(c) the relationship between the Member and any person conducting securities related business on account of the Member must be that of:

- (a) an employer and employee,
- (b) a principal and agent, or
- (c) an introducing dealer and carrying dealer.

From a practical perspective, Members are constrained in their abilities to properly supervise the trading activities taking place under such arrangements. Further, there is a danger that individuals may use these types of sales arrangements to make recommendations to divert client money to unregulated investment schemes or other purposes. Conflicts of interest that are not properly managed with respect to personal financial dealings involving other business pursuits may lead to situations where clients are exposed to significant potential harm. Members may also be exposed to significant liability.

Individuals engaging in registerable activities without proper registration may be subject to sanctions by provincial securities authorities. Further, Approved Persons that are found to be party to such arrangements may be subject to discipline under MFDA Rules.

Member Supervision

Members are reminded that they are responsible for establishing, implementing and maintaining policies and procedures to ensure that business is conducted in accordance with MFDA By-laws, Rules and Policies and with applicable securities legislation. This includes the implementation of policies and procedures designed to detect and prevent situations where Approved Persons may be involved in the facilitation of unregistered trading activities.

Such activities may be difficult for Members to identify through head office trade supervision alone. Branch managers are in a much better position to detect unlicensed activity carried on under such arrangements at the branch through direct observation. For this reason it is imperative that branch supervisory staff are properly trained on their responsibilities regarding branch oversight. In accordance with MFDA Policy 5, branch review programs should also address issues related to unregistered trading activity and adherence to the basic business conduct rules. Members should be conscious of these issues in situations where several Approved Persons in a branch office have transferred to a Member along with unregistered staff, or where Approved Persons that have been terminated by the Member continue to work out of a branch office.

Exempt Product Referrals

MFDA staff also cautions Members to be aware of referral arrangements which have been set up to, in effect, channel sales of exempt products outside of the Member firm. These arrangements may or may not involve direct payments between the parties to the agreement, but again are structured primarily to allow a non-registered individual to advise clients on products that should be sold through the registered Approved Person and the Member. Members should pay close attention to referral arrangements where such activity is suspected. For more information on this point, Members may refer to MFDA Member Regulation Notice MR-0043.