SOTOS

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Member Regulation Policy
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Re: Bulletin 26-0150 - Proposed Incorporated Approved Person Compensation Option

We write on behalf of Sotos LLP, a litigation firm whose practice includes acting for investors in claims involving investment dealers and financial advisors. We support CIRO's proposed adoption of an Incorporated Approved Person compensation option. Harmonizing the available compensation structures is, in general, not an investor protection issue, provided the final framework preserves the substance of existing investor rights and remedies.

1. Our Position

The proposal should proceed, but with two express safeguards in the rules and the required agreements:

a) **No corporate shield.** The incorporated structure must not limit, delay or complicate an investor's recourse against the individual advisor, the advisor corporation or the sponsoring dealer. To achieve this end, the flow through of liability to the advisor must be an unequivocal and written part of any amendment to permit this proposal. The arrangement must be see-through for negligence claims: incorporation must not shield the individual advisor or the advisor corporation from liability for negligent financial advice or services. The individual advisor and the advisor corporation must each maintain errors-and-omissions insurance of at least $1 million per occurrence and $3 million in the aggregate. The advisor corporation must also be subject to OBSI authority for all its activities involving or relating to financial advice.

b) **Genuine independent contractor status.** The option should not be available merely because a dealer-advisor contract labels the advisor an "independent contractor." Eligibility should depend on the actual relationship satisfying the applicable Income Tax Act requirements and the governing employee-versus-independent-contractor jurisprudence. As a friend to financial advisors, we urge CIRO to make the risks of improper claims of independence under

the ITA clear to advisors – they risk delayed payment of taxes, near usurious interest on the late payment, and penalties.

2. Support for harmonization

CIRO's proposal responds to the existing difference between the compensation options available to mutual fund dealing representatives and those available to other client-facing Approved Persons. A harmonized option can remove an unnecessary regulatory distinction and permit qualifying advisors to organize a genuine advisory business through a corporation, as members of several other professions may do.

We also support the proposal's basic regulatory architecture: the individual remains an Approved Person; the corporation becomes subject to CIRO oversight; the sponsoring dealer continues to supervise the activities carried on for it; and the relationship is documented through agreements among the dealer, the individual and the corporation. Those features should be retained and strengthened in the final wording.

3. The corporation must not operate as a shield against investor claims

Incorporation may alter the legal parties and the flow of compensation. It must not alter the investor's practical or legal ability to obtain redress. The final rules should say this directly, rather than leaving the point to implication, disclosure language or private contractual interpretation.

The framework should therefore be expressly "see-through" for negligence claims. As with a professional-corporation model that preserves personal responsibility for professional errors and omissions, an advisor corporation's interposition should not affect the individual advisor's liability for negligent financial advice or services. The advisor corporation should remain directly answerable as well, so that the structure adds a business and compensation vehicle, not a new liability defence.

At a minimum, the rules and mandatory tripartite agreement should provide that:

- an investor may pursue the individual Approved Person, the Incorporated Approved Person and the sponsoring dealer, among others, directly, without first exhausting a claim against any other person;
- nothing in the incorporated arrangement limits or displaces any liability that would otherwise exist at common law, in equity, under statute, or under CIRO rules prior to these arrangements;
- as between the investor and the regulated parties, the dealer may not rely on an allocation of responsibility, indemnity, corporate separateness, thin capitalization, dissolution or internal characterization of conduct to narrow the investor's recourse;
- all conduct undertaken through, for, or in connection with the dealer's advisory relationship remains subject to the dealer's complaint-handling and supervisory obligations;
- any disclosure to clients must state in plain language that incorporation does not reduce the responsibility of the advisor or the dealer and does not require the client to complain to or sue the corporation first. the individual Approved Person and the Incorporated Approved Person must each maintain errors-and-omissions insurance with limits of not less than $1 million per

occurrence and $3 million in the aggregate, and the required agreement must prohibit any gap in that coverage while the arrangement remains in force;

- the Incorporated Approved Person must be subject to OBSI authority, and OBSI's authority must extend to all activities of the Incorporated Approved Person involving or relating to financial advice; and

- for negligence claims, the arrangement must be see-through: neither the individual Approved Person nor the Incorporated Approved Person may rely on incorporation or corporate separateness to avoid or narrow liability for negligent financial advice or services.

For context, professional corporations governed by the Ontario *Business Corporations Act* through s. 3.4, requires that practice through a corporation "shall not be construed as limiting the professional liability of a shareholder of a professional corporation under an Act governing the profession for acts of the shareholder or acts of employees or agents of the corporation".[1] That *Act* also confirms that:[2]

- for the purposes of professional liability, the acts of a professional corporation shall be deemed to be the acts of the shareholders, employees or agents of the corporation;

- the acts of professional corporations to be the acts of the shareholders, employees or agents of the corporation;

- corporations practicing a profession are jointly and severally liable with the shareholders; and

- shareholders of professional corporations that are partners in a partnership or limited liability partnership have the same liability as though they were partners in their personal capacity.

In addition to the above, the proposal should explicitly confirm that firms remain vicariously liable for the conduct of advisors who opt to incorporate. These important protections, afforded to patients who are treated by physicians practicing through professional corporations for example, should be extended to the clients of advisors offering their services through a corporation. Otherwise, incorporation may become an unjustifiable shield from liability or execution on a judgment for advisors who choose to practice through corporations.

This safeguard is particularly important when a dispute involves conduct alleged to have been "off book" or outside the dealer's business. The addition of a corporation must not create a basis for a dealer to recharacterize conduct, redirect a complaint or require an investor to litigate corporate boundaries before reaching the merits. The final framework should preserve all existing investor arguments and remedies. It should not create a new defence.

4. Eligibility must turn on substance, not contractual labels

The tax premise of the proposal requires equal care. For income-tax purposes, an incorporated service provider may be treated as carrying on a personal services business where, but for the corporation, the individual could reasonably be regarded as an officer or employee of the recipient of the services, subject to the statutory exceptions. Whether a person is an employee or an independent contractor is

[1] *Business Corporations Act*, R.S.O. 1990, c. B.16 s. 3.4(1).
[2] *Business Corporations Act*, R.S.O. 1990, c. B.16 s. 3.4(2)-(4), (6).

determined from the real working relationship and the governing jurisprudence, not from the label chosen in the contract.

Accordingly, the incorporated option should be limited to advisors for whom the dealer has a reasonable, documented basis to conclude that the actual relationship is consistent with independent-contractor status under the Income Tax Act and applicable case law. A clause that baldly declares the advisor to be independent should not be sufficient.

The assessment should address the full factual relationship, including the parties' common intention as evidenced by their conduct and the recognized indicia of the relationship, such as control, ownership or provision of tools, ability to hire and compensate or subcontract, opportunity for profit, risk of loss, investment and responsibility for management. No single factor or contractual recital should be treated as determinative.

We recommend that CIRO require:

- a written dealer assessment, completed before approval and refreshed when the relationship materially changes;
- a certification from the dealer and advisor that the description of the relationship is accurate in practice, not merely in the written agreement;
- a prohibition on representing that CIRO approval confirms any tax outcome;
- clear disclosure that the advisor and corporation remain responsible for obtaining independent tax advice and complying with the Income Tax Act; and
- a requirement that the arrangement be amended or discontinued if the facts no longer reasonably support the intended status.

CIRO should not purport to make a binding tax determination. It should, however, avoid creating a regulatory structure that invites employee advisors to be relabeled as independent contractors solely to access a corporate compensation vehicle. That would create foreseeable tax, employment and investor-protection risk while undermining the stated rationale for the proposal.

5. Suggested express rule language

We recommend adding provisions substantially as follows:

Investor recourse. No Incorporated Approved Person arrangement, agreement, disclosure or corporate act shall limit, postpone or otherwise adversely affect any right or remedy of a client or other investor against the Approved Person, the Incorporated Approved Person or the Dealer Member. A client or investor shall not be required to pursue one of those persons before pursuing another. Any allocation of liability or indemnity among them is ineffective against the client or investor.

See-through liability for negligence. An Incorporated Approved Person arrangement shall be see-through for any claim alleging negligent financial advice or services. The liability of the Approved Person for such a claim is not affected by the use of an Incorporated Approved Person, and the Approved Person and Incorporated Approved Person may each be pursued directly in respect of the claim. Neither may rely on incorporation or corporate separateness to avoid or narrow liability that would otherwise arise.

Errors-and-omissions insurance. The Approved Person and the Incorporated Approved Person shall each maintain errors-and-omissions insurance with limits of not less than $1 million per occurrence and $3 million in the aggregate, on terms acceptable to CIRO, for all activities carried on under or in connection with the arrangement.

OBSI authority. The Incorporated Approved Person shall be a participating firm subject to the authority of the Ombudsman for Banking Services and Investments. That authority shall extend to all activities of the Incorporated Approved Person involving or relating to financial advice, whether or not the activity is characterized as dealer business, outside activity, corporate activity or otherwise.

Eligibility and status. A Dealer Member shall permit an Approved Person to use an Incorporated Approved Person arrangement only where the Dealer Member has documented a reasonable basis, having regard to the actual terms and circumstances of the relationship and applicable income-tax law and jurisprudence, for concluding that the relationship is consistent with independent-contractor status. A contractual designation or recital, without supporting facts and conduct, is insufficient.

Conclusion

Subject to these safeguards, we support the proposed Incorporated Approved Person compensation option. The reform should provide business-structure flexibility to advisors who genuinely operate independent businesses, while leaving investors in no worse position because a corporation has been inserted into the relationship. Express language on both points will improve certainty for investors, advisors, dealers, courts and regulators. Those safeguards should include see-through treatment for negligence claims, mandatory errors-and-omissions coverage for both the individual and the corporation, and comprehensive OBSI authority over the corporation's financial-advice activities.

Yours truly,

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