IIROC NOTICE

Rules Notice
Guidance Note
Dealer Member Rules

Please distribute internally to:
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Regulatory Accounting
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09-0209
July 13, 2009

International Financial Reporting Standards (IFRS) Survey Results and Staff Recommendations

Background

IIROC rules require that dealer members file an annual audited report [known as Form 1 or The Joint Regulatory Financial Questionnaire & Report (JRFQ&R)]. The audited Form 1 is a special purpose report that is restricted for use by IIROC and the Canadian Investor Protection Fund (CIPF). The focus of this special purpose report is the capital adequacy of the reporting dealer member measured on a solvency basis. This special purpose report is currently based on Canadian GAAP with specific accounting and reporting departures. The audit opinion of the regulatory special purpose report is based on CICA Handbook Section 5600.

The Canadian Accounting Standards Board (AcSB) has confirmed that use of International Financial Reporting Standards (IFRS) will be required in 2011 for publicly accountable profit-oriented enterprises. IFRS will replace Canada's current Generally Accepted Accounting Principles (GAAP) for these enterprises[1].

[1] Accounting Standards Board, Media Release entitled *Canadian Accounting Standards Board Confirms Changeover Date to IFRS*, dated February 13, 2008 and *Canadian Accounting Standards – Changeover to IFRSs: January 1, 2011* dated May 2009.

As the basis of accounting is moving to IFRS from Canadian GAAP, IIROC staff undertook detailed analysis of the impact on the adoption of IFRS by dealer members, by way of dealer member consultations, awareness seminars, focus group discussions involving representation by dealer members and panel auditors, and IFRS adoption impact survey by dealer members. Throughout the period of IFRS impact assessment, IIROC has communicated to its dealer membership through special Notices (#08-113 dated September 2008 and #09-0056 dated February 2009), and FAS[2] industry committee presentations (held in Vancouver on February 19, 2009 and in Toronto on May 21, 2009).

An integral part of IIROC staff analysis on the adoption of IFRS was a dealer membership survey - as directed by IIROC Board of Directors in January 2009 - to gauge the dealer membership's awareness and understanding of IFRS and to determine the impact of the implementation of IFRS compared to current regulatory reporting of the dealer member's business.

In February 2009, all dealer members were required to complete an IFRS survey by April 2009. The survey results would form the basis for IIROC staff's recommendation on the adoption of IFRS for special purpose regulatory reporting by dealer members to IIROC. On June 25, 2009, the IIROC Board was presented with the survey results and staff recommendations. The Board consented on the adoption of IFRS with specified accounting departures, where warranted for regulatory reporting purposes and further requested the publication of the survey results and staff recommendations for comment. Dealer members and panel auditors have an opportunity to provide written feedback within a 60-day period.

Purpose

The purpose of this notice is to provide the dealer membership with the survey results and IIROC staff recommendations with respect to the adoption of IFRS by the entire dealer membership.

Based on the survey results, IIROC staff recommends that all dealer members adopt IFRS for regulatory financial reporting - with some departures in relation to specific standards and subject to transitional relief.

For the change-over of Canadian GAAP to IFRS, the annual IIROC regulatory financial filing by dealer members will continue to be a special purpose report. IFRS will be the basis for the special purpose report with specific accounting and reporting departures, where warranted. International Standard on Auditing (ISA) 800 will continue to permit panel auditors to accept such engagements where "*...financial statements that are not prepared to meet the common information needs of a wide range of users may be prepared to meet the financial information needs of specific users. The information needs of such users will determine the applicable*

[2] Financial Administrators Section is a dealer member committee of IIROC.

financial reporting framework in such circumstances (which is referred to ... as 'another comprehensive basis of accounting').... Examples of financial reporting frameworks that are designed to address the needs of specific users include ... the financial reporting provisions ... for a set of financial statements prepared for regulatory purposes.[3]

Factors Considered

In its March 2009 exposure draft: *Adopting IFRS in Canada*, the AcSB has amended the definition of a publicly accountable enterprise (PAE) *in order to clarify the meaning of key terms such as "a public market" and "fiduciary capacity". The definition is also now stated in the positive, rather than the negative, as follows:*

> *A publicly accountable enterprise is an entity, other than a not-for-profit organization, or a government or other entity in the public sector that:*
>
> *(i) has issued, or is in the process of issuing, debt or equity instruments that are, or will be, outstanding and traded in a public market (domestic or foreign stock exchange or an over-the-counter market, including local and regional markets); or*
>
> *(ii) holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses.*
>
> *Banks, credit unions, insurance companies, securities brokers/dealers, mutual funds and investment banks typically meet the second of these criteria. Other entities may also hold assets in a fiduciary capacity for a broad group of outsiders because they hold and manage financial resources entrusted to them by clients, customers or members not involved in the management of the entity. However, if an entity does so for reasons incidental to one of its primary businesses ... , it is not considered to be publicly accountable.*[4]

IIROC needs to determine its position on the adoption of IFRS for all dealer member financial reporting. For determining its position, IIROC must take a number of factors into consideration, including:

- a dealer member's reporting obligations to an IFRS-reporting parent,
- a dealer member's contractual and legal obligations to file statutory financial statements,
- the cost and effort to comply with IFRS, and
- the regulatory value of implementing IFRS standards.

[3] International Standard on Auditing (ISA) 800, *The Independent Auditor's Report on Special Purpose Audit Engagements*, pp. 2 to 3.
[4] Accounting Standards Board, Exposure Draft: *Adopting IFRSs in Canada, II,* dated March 2009, page 3

In addition, IIROC must weigh all of these factors with IIROC's need to maintain a consistent basis of regulatory reporting for all dealer members to monitor their solvency.

Implication to the Dealer Membership

Although all dealer members are private companies, many[5] – but not all – dealer members are required by the AcSB to adopt IFRS because they are "publicly accountable enterprises". However, there is a segment of the dealer membership that the AcSB does not require to convert to IFRS. These firms primarily consist of Type 2 introducers. By the nature of their business models and design of their back-office operational arrangements, these firms are not custodians of customer monies or securities and are outside the scope of publicly accountable enterprises as defined by the AcSB.

To assess the impact on the adoption of IFRS for all dealer members, IIROC conducted an IFRS survey to solicit feedback from the dealer members. The objective of the survey was to specifically identify IFRS accounting and presentation changes, where the cost and effort to adopt are expected to be significant.

Summary of Survey Responses

IFRS survey responses were received by April 17, 2009. The survey data included responses from 193 (of 206) dealer members, a 94% response rate.

Part I of the survey included five questions relating to a dealer member's ownership and financial statement reporting obligations – whether it be to its public parent, its shareholders, its bank or another third party. Responses to Part I of the survey were used to classify a dealer member into one of three categories:

1. Dealer members who are owned directly or indirectly by a Canadian or foreign parent that is (or soon will be) reporting under IFRS. Dealer members that are subsidiaries[6] of a US public parent or a US regulated entity have been excluded from this category. The US has not definitively decided whether or not to adopt IFRS in 2014.

2. Dealer members who are either a self-clearing firm or a Type 3 or 4 Introducer that does not fall under category 1. These firms have fiduciary responsibilities to a broad group and hold or stand ready to hold client assets. Regardless of the back-office arrangement, these firms meet the definition of a publicly accountable enterprise (PAE).

[5] All dealer members are private companies. Many dealer members are direct or indirect subsidiaries of public parent holding companies.
[6] Of the 17 dealer members, 15 firms are in Category 2, and 2 firms in Category 3.

Also within this category are dealer members, including Type 2 introducers that are required or may be required to file statutory financial statements by law or contractual obligation.

3. Dealer members who are either ATSs (alternative trading systems) or Type 2 introducers that do not fall under categories 1 or 2. These are firms that do not meet the definition of a PAE and, therefore, the mandatory adoption of IFRS would not apply.

In summary, the following table sets out how the surveyed dealer members are broken down amongst these three categories.

Category 1:	52 dealer members (approximately 25% of the dealer membership). Within this group, there are seven Type 2 introducers.
Category 2:	90 dealer members (a little less than 50% of the dealer membership). Within this group, there are 16 Type 2 introducers.
Category 3:	The remaining 25% – 51 dealer members that are Type 2 introducers.

The survey results clearly show that 74% of the dealer membership will need to comply with IFRS. The survey results also show that some Type 2 introducers (23 dealer members) will need to comply with IFRS as a result of being a subsidiary of an IFRS-compliant parent and/or as a result of legal or contractual obligations to issue IFRS compliant statutory financial statements.

Part II of the survey had five questions, which related to the level of IFRS awareness at the dealer member. The survey results indicated that the Boards of Directors (or equivalent) of approximately 93% of the respondents have been made aware of the change-over to IFRS.

The level of awareness appears to be positively correlated to the size and ownership of a dealer member. Dealer members that are subsidiaries of IFRS-compliant parents are more structured in their IFRS conversion plan because it is driven by the parent. As the size of the firm gets smaller, the chief financial officer (CFO) is most likely to be the sole person responsible for the task of preparing for the IFRS change-over.

Part III of the survey contained 60 questions relating to the impact of applying IFRS on two aspects: (1) the cost and effort to comply; and (2) whether the resulting accounting changes would materially affect the decision-making processes within the dealer members.

Dealer members were asked to rate these two aspects to each of the 60 questions from 1 to 3, where 3 was 'high" for impact/effort. 42 of the 60 questions received at least 1 'high' rating score. When reviewing the questions that received at least one 'high' rating, IIROC identified commonalities to the responses.

The commonalities are grouped and ranked into four broad issue areas:

1. Concerns regarding the operational implications of preparing additional detailed financial statement note disclosures,

2. Concerns over the burden in the transitional year of producing IFRS compliant comparative statements as part of the first IFRS financial statements,

3. Presentation issues, specifically accounting system changes necessary to report all balance sheet and income statement items on a gross basis, and

4. Issues relating to the valuation of receivables and payables (i.e. present value discounting).

The survey scoring showed that the areas of greatest concern by the dealer membership were added detailed financial statement note disclosures and transitional reporting requirements. Interestingly, more firms in category 2 scored 'high' ratings. In contrast, and as expected due to the balance sheet simplicity of Type 2 introducers, firms in category 3 rated very few survey questions as 'high'.

Staff Recommendations

IIROC staff recommends that all dealer members adopt IFRS, but with exemptions from specific accounting standards. These exemptions are prescribed by IIROC and are departures from IFRS.

Currently, Canadian GAAP with mandated departures from specific accounting standards is the prescribed basis of accounting for regulatory reporting purposes. The audit opinion for the regulatory filings pursuant to this prescribed basis of accounting is currently permitted under CICA Handbook Section 5600. Examples of current exemptions include the non-consolidation of non-dealer member entities and non-inclusion of the Statement of Cash Flows. These current departures are on the basis that compliance with the accounting standard would not fairly represent the financial condition of the dealer member on a stand alone basis, or there is minimal regulatory value in its presentation.

For regulatory reporting purposes, IFRS also makes allowances for departures in accounting standards where prescribed by a regulatory authority. This is set out in International Standard on Auditing (ISA) 800 – *The Independent Auditor's Report on Special Purpose Audit Engagements*. This provides IIROC with the opportunity to permit deviations from IFRS where warranted, specifically in those instances where the regulatory reporting value is low relative to the cost/effort to comply with IFRS, or the financial statements would not fairly represent the financial condition of the regulated entity on a stand alone basis.

With the adoption of IFRS, IIROC staff recommends the continuance of certain exemptions, including the non-consolidation of non-dealer member entities and non-inclusion of the Statement of Cash Flows.

Three key areas of exemptions from IFRS are recommended:

1. *Concern regarding note disclosures*

   The survey results showed that one of the concerns relates to the operational implications of preparing detailed financial statement note disclosures. IIROC staff believes that detailed financial statement note disclosures, such as those required for financial instruments, are of minimal regulatory value. The combination of IIROC's capital formula and framework, the regulatory approval of organizational structures and business models, and the required periodic financial disclosure already provide adequate information to effectively oversee and regulate a dealer member. IIROC staff recommends that certain IFRS specific[7] financial statement note disclosure requirements are not necessary and, therefore, IIROC staff proposes to allow exemptions from certain specific note disclosure requirements.

2. *Concern regarding one-time transitional requirements*

   The second area of concern identified in the survey is the IFRS requirement to produce comparative financial data for the first IFRS financial statements. The need for comparative financial data will necessitate parallel sets of accounting books and records, one prepared in accordance with Canadian GAAP and the other in accordance with IFRS, for the transition year. IIROC staff believes that restatement of the prior year's comparative financial data to IFRS [from Canadian GAAP] is of minimal regulatory value[8] compared to the costs that would be incurred.

   As an alternative and compensating control, IIROC staff recommends that the dealer member provide a reconciliation of the audited opening retained earnings for the first year of conversion. For firms with a December year-end, this is the retained earnings balance as at January 1, 2011.

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[7] Note disclosures will continue to be an integral part of the annual regulatory financial filings under IFRS. However, IIROC staff recommends that expanded note disclosure for specific areas, such as the qualitative and quantitative note disclosures for financial instruments, need not be required.

[8] The focus of the regulatory financial report is the solvency of a dealer member.

3. *Issues relating to valuation*

The survey also highlighted the issue of the valuation of receivables and payables, such as client balances and broker balances. Under both Canadian GAAP and IFRS, receivables and payables must be valued periodically. As the securities industry is in the business of buying and selling securities and any related receivables and payables are a direct consequence of security trading activities (as opposed to lending activities by financial institutions), IIROC staff believes that periodic valuation of receivables and payables provides minimal regulatory value, but imposes significant cost and effort to comply. IIROC staff, therefore, recommends an exemption/accommodation from this specific accounting standard under IFRS and does not require this valuation.

Concerns regarding presenting balances on a gross basis (no netting)

Unlike Canadian GAAP or IFRS, IIROC allows the netting of receivables from and payables to the same counterparty, and the netting of revenues and expenses for specific business transactions. Generally, netting is not allowed under Canadian GAAP or IFRS. Currently, IIROC permits a departure from Canadian GAAP in this respect.

Presentation of assets, liabilities, revenue and expenses is a fundamental objective under IFRS. As such, it is the view of IIROC staff that dealer members must comply with this fundamental IFRS requirement. IIROC staff therefore recommends that dealer members be required to comply with the gross presentation of assets, liabilities, revenues and expenses pursuant to IFRS. The survey results showed that this specific concern is systems-dependent. To assist dealer members with their systems-dependent issues, IIROC intends to work together with dealer members towards an industry-wide EDP systems solution.

Please refer to the Appendix 1 for the 'Summary of analysis and staff recommendations'.

Who is affected and how will they be affected by IIROC staff recommendations regarding the adoption of IFRS?

A mandated change to IFRS will affect all category 3 dealer members[9] consisting mainly of Type 2 introducers and representing approximately 25% of IIROC dealer membership. IIROC is sensitive to the smaller dealer members and their relative fewer resources to cope with the change-over to IFRS.

The survey results indicated that these dealer members – primarily the Type 2 introducers – have concerns in two general areas: financial statement note disclosures and the transitional IFRS requirements.

[9] Dealer members in categories 1 and 2 will need to comply with IFRS as a result of being a subsidiary of an IFRS-compliant parent and/or as a result of legal or contractual obligations to issue IFRS compliant statutory financial statements.

IIROC staff is recommending exemptions from IFRS in these two areas.

By addressing these two areas of concern, IIROC staff believes this will minimize the challenges that these dealer members will face when converting to IFRS and still allow IIROC to effectively and consistently regulate and oversee the financial soundness of all dealer members.

What about the alternative *"Private Enterprise GAAP"* for small dealer members?

The AcSB has released its draft exposure of a new set of accounting standards – *Private Enterprise GAAP* – for firms that need not comply with IFRS. For the 51 dealer members in category 3 that are not required by the AcSB to change-over to IFRS, *Private Enterprise GAAP* would be applicable.

It is IIROC staff's view that for investment dealers, *Private Enterprise GAAP* is not a viable alternative set of accounting standards. For instance, *Private Enterprise GAAP* requires the valuation of most financial instruments at historical cost (as opposed to market value or fair value). Adopting *Private Enterprise GAAP* would be a step backwards – as IIROC implemented the Financial Instrument accounting standard as set out in CICA Handbook Section 3855 and issued Member Regulation Notice MR 431 in 2006 requiring fair value accounting[10].

Therefore, IIROC staff does not recommend the use of the proposed new set of accounting standards for non-PAEs – *Private Enterprise GAAP* – for dealer members as it is a step in the wrong direction.

Challenges today and in the future

The challenge for IIROC is a one-time adoption of IFRS by its dealer members with limited exemptions. These exemptions will be kept to a minimum, where the accounting standards do not fairly represent the financial condition of the regulated entity on a stand alone basis, or have minimal regulatory value but will require significant cost and effort to comply.

In order to assist the dealer membership in its change-over to IFRS, IIROC has established an IFRS website[11], accessible only to dealer members. All IFRS-related documents and webcasts are centrally located in the IFRS website.

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[10] Under 'Canadian GAAP – Differential Accounting', a private company can scope out of certain accounting standards. However, for regulatory financial reporting, IIROC does not permit the use of 'Differential Accounting' by dealer members.

[11] **For dealer members only**: To register, please visit: http://iiroc.projectspaces.com/no_login/invite/415_4644f12a526c6e7b66c898e9bb8e5cf6 Thereafter, upon receipt of a confirmation e-mail, dealer members can access the IFRS website through the following web-link: http://iiroc.projectspaces.com

IIROC has raised awareness by developing a series of mini-information sessions delivered through webcasts. These webcasts were developed to assist dealer members in completing the IFRS survey and have aided in raising the level of awareness.

On a go forward basis, IIROC will continue to deliver IFRS-related information sessions through a combination of delivery channels: webcasts, notices, reference documents and Members' seminars across the country.

Request for comments

IIROC is providing an opportunity for dealer members and panel auditors to comment on the survey results and staff recommendations within a 60-day response period.

Comments should be directed to IFRS@iiroc.ca by **Monday, September 14, 2009**.

Appendix 1

Summary of Analysis and Recommendations

Area of Concern	Analysis	Recommendation
Operational implications of preparing additional detailed note disclosures	Detailed note disclosures such as those required for financial instruments are of minimal regulatory value. IIROC's capital formula and framework together with the regulatory approval over organizational structures and business model coupled with required periodic financial disclosure already provide information to effectively oversee and regulate a dealer member.	Exemption from certain specific note disclosure requirements.
One-time transitional requirements, including comparative financial statements as part of the first IFRS financial statements	Comparative financial data is of minimal regulatory value. The rationale for maintaining two sets of accounting records is primarily to enable a dealer member to produce the financial statements of the prior year and to restate them from Canadian GAAP to IFRS for comparative purposes. As a regulator, IIROC's focus is the solvency (as opposed to the going concern) of a dealer member.	Exemption from this specific one-time transitional requirement. As a compensating control, IIROC staff recommends that the dealer member provide a reconciliation of the audited opening retained earnings at the conversion date.
Issues relating to valuation	Periodic valuation of receivables and payables provides little or no regulatory value – but imposes significant cost and effort to comply. The securities industry is in the business of buying and selling securities. Any related receivables and payables are a direct consequence of security trading activities (as opposed to lending activities by financial institutions).	Exemption from this specific accounting standard – the periodic valuation of receivables and payables.
Presentation issues, specifically accounting system changes necessary to report all balance sheet and income statement items on a gross basis (no netting)	Presentation of true assets, liabilities, revenue and expenses is fundamental under IFRS. Unlike Canadian GAAP and IFRS, IIROC allows the netting of receivables from and payables to the same counterparty, as well as the netting of revenues and expenses for specific business transactions. As a general rule, netting is not allowed under Canadian GAAP and IFRS. Currently, this is a regulatory departure from Canadian GAAP.	Dealer members must comply with this fundamental IFRS requirement. IIROC recommends the discontinuance of the exemption from the gross presentation of assets, liabilities, revenue and expenses. To assist dealer members with their systems-dependent issues, IIROC intends to work together with dealer members towards an industry-wide EDP systems solution.