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Investment Industry Regulatory Organization of Canada
Organisme canadien de réglementation du commerce des valeurs mobilières

IIROC NOTICE

Rules Notice
Request for Comments
Dealer Member Rules

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Contact:
Sherry Tabesh-Ndreka
Policy Counsel, Member Regulation Policy
416.943.4656
stabesh@iiroc.ca

10-0085
March 26, 2010

Plain language rule re-write project – Proposed Rule 3100, *Business Conduct* and Proposed Rule 3200, *Client Accounts*

Summary of the nature and purpose of the proposed Rule

On January 26, 2010, the Board of Directors ("the Board") of the Investment Industry Regulatory Organization of Canada ("IIROC") approved the publication for comment of proposed Dealer Member Rules 3100 relating to business conduct and 3200 relating to client accounts, which includes rules relating to accounts with options contracts and futures contracts and discretionary and managed accounts (collectively referred to as the "proposed Rules").

IIROC has undertaken a project to rewrite its rules in plain language. The primary objective of this project is to develop a set of rules that is more clear, concise and organized, without changing the rules themselves. In addition we have identified a number of rules that also require substantive revisions.

The new rules will be submitted to the Board and issued for public comments in 8 tranches. The first tranche submitted to the Board and issued for public comments includes the following two sets of substantive change rules:

(1) Rule 3100, *Business Conduct*; and

(2) Rule 3200, *Client Accounts*.

The existing rules relating to business conduct standards and clients accounts have been identified as requiring substantive revisions in order to:

- eliminate unnecessary rule provisions;
- clarify IIROC's expectations with respect to certain rules;
- ensure that the rules reflect actual IIROC practices; and
- ensure consistency with other IIROC Dealer Member rules and applicable securities legislation.

Proposed Rule 3100 is a consolidation of the relevant requirements currently set out in IIROC Dealer Member Rules 17, 29, 1300 and 1500, relating to Business Conduct.

Proposed Rule 3200 is a consolidation of the relevant requirements currently set out in IIROC Dealer Member Rules 29, 200, 1300, 1500, 2500, 2700 and 3200, relating to client Accounts.

Issues and specific proposed amendments

Current rules

Other than the proposed substantive revisions set out below, the proposed Rules 3100 and 3200 do not create any new obligations for Dealer Members and have been drafted to clarify the existing Rules with respect to business conduct standards and client accounts, respectively.

Proposed rules

In addition to the plain language rewrite of the existing requirements to create proposed Rule 3100, the following substantive amendment is proposed:

- *Business conduct*: Current Dealer Member Rule 1300.1(o) states that Dealer Members must use "due diligence to ensure that acceptance of any *order* is within the bounds of good business practice". In order to ensure consistency with other IIROC Dealer Member Rules, including the suitability requirements, the proposed Rule will clarify that Dealer Members are required to use due diligence to ensure that both *orders and recommendations* are within the bounds of good business practice.

In addition to the plain language rewrite of existing requirements to create proposed Rule 3200, the following substantive amendments are proposed to parts A, B and/or C of proposed Rule 3200 relating to general client account related requirements:

- *Client identification*: Current Dealer Member Rules require each dealer to use due diligence to know every client and to also complete the applicable information on Form 2. Form 2 includes questions designed to determine how long the advisor has known the client,

whether they have met the client face to face and whether the client is an insider of any public corporation. The current Dealer Member Rules do not specifically state that the Dealer Member has to identify each client and determine whether the client is an insider of a reporting issuer. While current IIROC Dealer Member Rules only impose this specific requirement when dealing with trust accounts and corporate accounts it should be noted that Dealer Members are currently required to identify each new client in order to comply with the federal anti-money laundering legislation. Furthermore, National Instrument 31-103 ("NI 31-103") includes a requirement that Dealer Members identify every new client and determine whether that client is an insider of a public company. For consistency with NI 31-103, proposed Rule 3200 will require that each Dealer Member use due diligence to establish the identity of every new client and if there is cause for concern, then make inquiries as to the reputation of the client. Furthermore, for consistency with NI 31-103, proposed Rule 3200 (part A) will require each Dealer Member to use due diligence to establish whether the client is an insider of a reporting issuer or other issuer whose securities are publicly traded.

- Under the current Dealer Member Rules, when opening an initial account for a corporation, partnership or similar entity, Dealer members must identify any individual who is a beneficial owner, or exercises direct or indirect control over, more than 10% of the corporation, partnership or similar entity. However, Dealer Members are not subject to this requirement when opening an account for an entity that is, or is an affiliate of, a financial institution that is subject to a satisfactory regulatory regime in the country in which it is located. The proposed Rule codifies the current interpretation of the above noted exemption by clarifying that an institution is not subject to a satisfactory regulatory regime if it is exempted from the substantive requirements of the regulatory regime. Furthermore, Dealer Members are also not subject to the above noted identification requirement for any financial institution located in a particular country that may be exempted by IIROC. The proposed Rule codifies the current interpretation of this exemption by clarifying that the exemption may be provided not only to a specific institution in a particular country but also, to a class of institutions or all institutions located in a particular country.

- *Account Information for Institutional Clients*: The current Dealer Member Rules set out the definition of an Institutional Client. Although, it is expected and implied that IIROC Dealer Members would verify that a client qualifies as an Institutional Client prior to dealing with the client as such, it is not specifically required in the current IIROC Dealer Member Rules. Proposed Rule 3200 (part B) will specifically require Dealer Members to verify that a client qualifies as an Institutional Client before dealing with the client as such.

- *Account information*- To codify existing practices, to assist Dealer Members in complying with their general conduct requirements, and to ensure the accuracy of the account information, proposed Rule 3200 (part B) will specifically require that Dealer Members

maintain account documents and records that meet not only IIROC requirements but also requirements imposed by all other applicable legislation.

- *Leverage Risk Disclosure Statement*: The current IIROC Dealer Member Rules require that a Leverage Risk Disclosure Statement be provided to each client. This rule was introduced in response to National Instrument 33-102 which requires that a leverage disclosure statement be provided to each retail client[1]. Consistent with current expectations and practice, historical records show that the current IIROC Dealer Member rule was only intended to apply to retail clients, however, the current IIROC Dealer Member Rule does not make specific reference to this limitation and merely states that it must be disclosed to each client. In order to ensure that the proposed Rule 3200 remains true to the original objectives (i.e. that it only apply to retail clients) and is consistent with current expectations and practices, proposed Rule 3200 (part B) will clarify that the Leverage Risk Disclosure Statement requirement is applicable only when dealing with retail clients.

  Furthermore, Proposed Rule 3200 will require Dealer Members to obtain an acknowledgment from each client who receives a copy of the Leverage Risk Disclosure Statement. This requirement was added to proposed Rule 3200 to ensure consistency with other similar provisions within the IIROC Dealer Member Rules, such as the requirement to obtain an executed copy of a Margin Account Agreement from the client as well as the requirement to obtain an acknowledgement of an options contract account or futures contract Risk Disclosure Statement from the client. There is no compelling reason that such an acknowledgement would not be obtained from a client with respect to a Leverage Risk Disclosure Statement in comparison to other risk disclosure statements.

- *Client mail* – The current IIROC Dealer Member Rules require that all "hold mail" instructions be evidenced by the client in writing, and controlled/reviewed on a regular basis. The existing requirements do not however, provide a time limit relating to "hold mail" restrictions. The current expectation is that "hold mail" restrictions will only be permitted on a temporary basis. Consistent with the purpose of "hold mail" restrictions, proposed Rule 3200 (part B) will specify that Dealer Members are required to set reasonable time limits of no longer than 6 months, in any 12 month period, on "hold mail" restrictions in their procedures. The time limit is to ensure that hold mail restrictions are not applied to any account on a continuous basis. However, IIROC staff recognize that there may be limited circumstances under which a longer period may be acceptable. Accordingly, the proposed Rule provides that a longer hold mail period may be in force for an account under the following conditions: i) it is permitted by the Dealer Member's policies and procedures, ii) the Dealer Member has policies and procedures to closely

[1] National Instrument 33-102 was repealed and replaced with equivalent provisions in National Instrument 31-103 as at September 28. 2009.

supervise the account, and iii) an appropriate Supervisor pre-approves the extended hold mail period.

In addition to the plain language rewrite of existing requirements to create proposed Rule 3200, the following substantive amendments are proposed to part D of proposed Rule 3200 dealing with options contracts, futures contracts and futures contract option accounts:

- *Letter of undertaking:* Current Dealer Member Rule 1800 stipulates that instead of a Futures Contract or Futures Contract Options Trading Agreement, a Dealer Member may obtain a letter of undertaking if the client, among other things, is "a dealer on its own behalf or a dealer on behalf of its customer if the dealer is required to maintain with its customer an account agreement substantially similar to those set out in Rule 1800.9".The term "dealer" as set out above is not defined in the IIROC Dealer Member rules. Accordingly, proposed Rule 3200 uses the term *regulated entity* rather than *dealer*. A regulated entity, as set out in Form 1 - Joint Regulatory Financial Questionnaire and Report of the IIROC Dealer Member Rules, is defined as a member of any association or exchange that:

    - has an investor protection regime similar to the CIP Fund;
    - has similar segregation and financial reporting requirement to those of IIROC;
    - sets out specific requirements relating to segregation of client credit balances and the margining of client accounts; and
    - is subject to regulatory oversight of a government agency or a self-regulatory organization.

  The revision of Rule 1800 contained in proposed Rule 3200 ensures the use of consistent terms in the IIROC Dealer Member Rules, where applicable. The revision will also clarify IIROC's expectations with respect to the question of when a Futures Contract or Futures Contract Options Trading Agreement is required and when a Letter of Undertaking will suffice.

- Current Dealer Member Rule 1900 stipulates that instead of an Options Trading Agreement, a Dealer Member may obtain a letter of undertaking if the client is an "acceptable institution" or an "acceptable counterparty". Unlike current Dealer Member Rule 1800, which allows a Dealer Member to simply obtain a letter of undertaking when dealing with a dealer acting on its own behalf or on behalf of a customer, current Dealer Member Rule 1900 does not allow Dealer Members to obtain a letter of undertaking, rather than an Options Trading Agreement, when dealing with another dealer that trades in options contracts. Given that Dealer Members, entering into option dealing relationships with acceptable institutions and acceptable counterparties have the option of

obtaining either a Letter of Undertaking or an Options Trading Agreement, there is no compelling reason not to allow Dealer Members to similarly obtain a Letter of Undertaking when dealing in options with regulated entities.

Similarly, the term "regulated entity" will substitute the term "dealer". This revision will create consistency between the options account and futures account sections of proposed Rule 3200.

- *Reports:* Dealer Member Rule 1900 sets out requirements with respect to options reports filed with IIROC. Dealer Member Rule 1800 sets out requirements with respect to futures contracts and futures contract options reports filed with IIROC. Currently, IIROC does not expect Dealer Members to file any such reports. Consequently, any reference to such reporting requirements should be omitted to ensure consistency with current practices and expectations. Proposed Rule 3200 has been updated accordingly.

In addition to the plain language rewrite of existing requirements to create proposed Rule 3200, the following substantive amendments are proposed to part E of proposed Rule 3200 relating to discretionary and managed accounts:

- *Discretionary trading*: Under the current Dealer Member Rules, the prohibition against discretionary trading, unless in a discretionary or managed account, is implied through existing rules relating to the proper operation of discretionary and managed accounts and more specifically, captured through the definition of a discretionary account. Proposed Rule 3200 more clearly sets out the prohibition against discretionary trading, including the prohibition against time and price discretion.

- *Term limit on discretionary accounts*: The current Dealer Member Rules state that a discretionary account cannot be opened for a term of longer than twelve months unless the Dealer Member has satisfied the Corporation that a longer term is appropriate and the customer is aware. The intent and nature of discretionary accounts is to accommodate temporary situations for which a client may want to provide discretionary authority to his/her advisor. It is the position of IIROC staff that it is not appropriate for discretionary authority to be granted to a Registered Representative on a long term basis and that client awareness and satisfaction of the Corporation without any checks and balances is not necessarily sufficient to address issues that may arise from granting discretionary authority on a long term basis. For consistency with the purpose of discretionary accounts, Proposed Rule 3200 will prohibit operating a discretionary account for a period in excess of twelve months. An alternative to the proposed Rule considered was that a term longer than 12 months would only be permitted if the Dealer Member obtains written client authorization, closely supervises the account, and receives pre-approval from IIROC. However, it seemed more appropriate to impose an absolute time restriction as it is consistent with the intent of discretionary accounts and with the practice adopted by many IIROC Dealer Members. The absolute time restriction will also provide more

certainty in terms of conditions under which an account may be accepted on a discretionary basis. If an approval process was adopted, then it may result in unintended inconsistencies over time.

- *Restrictions in a discretionary account*: Current Dealer Member Rules prohibit the *holding* of publicly traded securities of a Dealer Member or its affiliates in a discretionary account. The proposed provision restricts an *acquisition* of such securities within discretionary accounts. The proposed Rule was revised to allow for these types of securities to be held in a discretionary account if these securities were held by a client prior to the creation/acceptance of the discretionary account. Without this carve out, a client wishing to convert an account into a discretionary account would have no choice but to: 1) sell the offending securities, despite the fact that they may otherwise be suitable for the client; or 2) abandon their plan to grant discretionary authority over the account; or 3) transfer the security position to another non-affiliated Dealer Member. It is the position of IIROC staff that it is more appropriate to prohibit a subsequent acquisition of such securities than to prohibit the continued holding of a previously acquired position that may otherwise be suitable for the client.

- *Managed Account Agreement*: Current Dealer Member Rules require that a client's investment objectives and risk tolerance for a managed account be described in the Managed Account Agreement. As per proposed Rule 3200, the Managed Account Agreement can either describe, or incorporate by reference, the applicable investment objectives or risk tolerance of the client that may be set out elsewhere. This type of flexibility is proposed for consistency with other account document related provisions.

- *Borrowing from a client*: The current Dealer Member Rules state that client consent is required in order for a managed account to make a loan to a responsible person. The proposed revisions eliminate this provision as it is inconsistent with general business conduct standards and current practices. The revision is proposed on the basis that borrowing from clients or otherwise engaging in personal financial dealing with clients is inappropriate conduct, irrespective of client consent.

- *Conflict of interest provisions*: The existing conflict of interest rules relating to managed accounts directly and specifically apply to portfolio managers. The application of the conflict of interest rules to sub-advisors is however captured within the general conditions under which a managed account may be managed by a sub-advisor. These conditions include a requirement that the sub-advisor be subject to legislation or regulations equivalent to the conflict of interest provisions set out in the IIROC Dealer Member Rules. Alternatively, the Dealer Member may enter into a written agreement with the sub-advisor which states that the sub-advisor will comply with the relevant conflict of interest rules as set out in the IIROC Dealer Member Rules. The language contained within proposed Rule 3200 will make it clear that the conflict of interest rules apply equally to both portfolio

managers and sub-advisors authorized to effect trades in managed accounts. This proposed revision is consistent with the current requirements applicable to sub-advisors and is merely a clarification of the existing requirement.

- *Application of the client priority rule within managed accounts*: Currently Dealer Members are required to give priority to *client orders* over all other orders for the same security at the same price. This rule is often referred to as the "Client Priority Rule". The phrase "*client orders*" does not include an order for an account in which the Dealer Member or an employee of the Dealer Member has a direct or indirect interest, other than the commission charged.

  The current Dealer Member Rule relating to managed accounts permits accounts of partners, Directors, Officers, Approved Persons, employees or agents of a Dealer Member who participate in the managed account program to be included as client orders. This is considered an exemption from the Client Priority Rule.

  Proposed Rule 3200 more clearly sets out IIROC's position that the above noted exemption will not apply to those involved in the investment decision making process. To clarify, *client orders* will not include accounts of partners, Directors, Officers, Approved Persons, employees and agents of a Dealer Member who participate in the managed account program if they are part of the investment decision making process. This revision is consistent with the purpose and scope of the existing Rule as set out in previously issued guidance. This amendment is proposed on the basis that it is inappropriate for those involved in the investment decision making process of a managed account program to receive client priority through their participation in the managed account program.

The full text of the proposed plain language Dealer Member Rules 3100 and 3200 is attached.

Rule-making process

IIROC Staff involved representatives of Dealer Members in the rule development process, through preliminary consultations. Proposed Rule 3100 and proposed Rule 3200 were made available to all Dealer Members for their input through a Dealer Members-only website. A designated Compliance and Legal Section ("CLS") working group also reviewed and provided comments on proposed Rule 3100 and proposed Rule 3200 (parts A,B,C and E). Copies of the proposed Rules 3100 and 3200 were then made available to all CLS Members for their input and comments. A number of changes to the draft proposal were made in response to the comments IIROC received through these consultations.

The proposed Rules were approved for publication by the IIROC Board of Directors on January 26, 2010.

The text of proposed plain language Rules 3100 and 3200 is set out in Attachments A and B. The text of the existing Dealer Member Rules to be repealed is set out in Attachment C. A table of concordance is included as Attachment D.

Issues and alternatives considered

An alternative to the inclusion of the amendments being proposed was to leave the rules substantively as they were prior to the plain language rewrite. IIROC staff considered other pending projects and proposals as well as the extent of the potential, substantive changes identified in order to decide which of the substantive changes would be proposed as part of the plain language rule rewrite project. Those substantive changes which were originally identified as part of the plain language rule rewrite project, but which were ultimately excluded from the plain language rewrite project are being pursued as separate rulemaking projects.

In dealing with proposed Rule 3100 "Business Conduct", IIROC staff specifically considered whether pending proposals currently being worked on by IIROC staff, with respect to personal financial dealing and general business conduct standards should also be brought forward at this time. In particular, IIROC staff considered bringing forward the personal financial dealing rule which includes proposals to prohibit registrants from borrowing money from clients, acting as a power of attorney for clients and accepting any gratuity from clients, subject to specific exemptions. Given the materiality of those pending proposals, IIROC staff concluded that it is best to deal with those revisions as separate rule proposals, which will be considered at a later time.

With respect to proposed Rule 3200, the client account related proposals, IIROC staff is in the process of issuing guidance that is consistent with previously proposed, Form 2 related rule amendments[2]. Given the length of the proposed Guidance Note, IIROC staff concluded that it is best to deal with those issues as a separate project.

Proposed Rule classification

Statements have been made elsewhere as to the nature and effects of the proposed Rules. The purposes of the proposed Rules are to:

- Ensure compliance with securities laws;
- Prevent fraudulent and manipulative acts and practices;
- Promote just and equitable principles of trade and emphasize the duty to act fairly, honestly and in good faith;

[2] The Form 2 proposed rule amendments were withdrawn in July 2009.

- Foster fair, equitable and ethical business standards and practices; and
- Promote the protection of investors.

IIROC staff propose that rules pertaining to business conduct standards and client accounts should be rewritten to reflect actual IIROC expectations, to enhance the clarity of the rule and to ensure consistency with applicable securities legislation. These amendments are in addition to the plain language rewrite of the existing rule provisions. The Board has determined that the proposed amendments are not contrary to the public interest.

Due to the extent and substantive nature of these proposed amendments, they have been classified as Public Comment Rule proposals.

Effects of proposed Rule on market structure, Dealer Members, non-members, competition and costs of compliance

With proposed plain language Rules 3100 and 3200, Dealer Members will benefit from enhanced clarity and certainty in rules relating to business conduct standards and client account requirements.

The proposed Rules will not have any significant effects on Dealer Members or non-Dealer Members, market structure or competition. Furthermore, it is not expected that there will be any significant, increased costs of compliance as a result of the proposed Rules.

The proposed Rules do not impose any burden or constraint on competition or innovation that is not necessary or appropriate in the furtherance of IIROC's regulatory objectives. The proposed Rules do not impose costs or restrictions on the activities of market participants that are disproportionate to the goals of the regulatory objectives sought to be realized.

Technological implications and implementation plan

There should not be significant technological implications for Dealer Members as a result of the proposed amendments. Proposed plain language Rules 3100 and 3200 will be implemented at the same time as the rest of the plain language rules.

Request for public comment

Comments are sought on the proposed amendments. Comments should be made in writing. Two copies of each comment letter should be delivered within 90 days of the publication of this notice. One copy should be addressed to the attention of:

Sherry Tabesh-Ndreka
Policy Counsel
Investment Industry Regulatory Organization of Canada
Suite 1600, 121 King Street West
Toronto, Ontario
M5H 3T9
stabesh@iiroc.ca

A second copy should be addressed to the attention of:

Manager of Market Regulation
Ontario Securities Commission
20 Queen Street West
19th Floor, Box 55
Toronto, Ontario
M5H 3S8
marketregulation@osc.gov.on.ca

Those submitting comment letters should be aware that a copy of their comment letter will be made publicly available on the IIROC website (www.iiroc.ca under the heading "IIROC Rulebook - Dealer Member Rules - Policy Proposals and Comment Letters Received").

Questions may be referred to:

Sherry Tabesh-Ndreka
Policy Counsel, Member Regulation Policy
Investment Industry Regulatory Organization of Canada
416-943-4656
stabesh@iiroc.ca

Attachments

Attachment A - Proposed Rule 3100

Attachment B - Proposed Rule 3200

Attachment C - Text of the relevant provisions of Dealer Member Rules 17, 29, 200, 800, 1300, 1500, 1800, 1900, 2500, 2700 and 3200

Attachment D - Table of Concordance