

IIROC NOTICE

Rules Notice Request for Comments

Dealer Member Rules

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Plain language rule re-write project – Dealing with clients, Proposed Rules 3400-3900

Summary of the nature and purpose of the proposed Rule

On June 24, 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 3400 relating to suitability requirements, 3500 relating to sales practices, 3600 relating to communications with the public, 3700 relating to handling and reporting complaints and internal investigations, 3800 relating to books and records, and 3900 relating to supervision (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. This tranche submitted to the Board and issued for public comments includes the following six sets of substantive change rules:

- (1) Rule 3400, *Suitability*;
- (2) Rule 3500, *Sales practices*;
- (3) Rule 3600, *Communication with the public*;
- (4) Rule 3700, *Reporting and handling of Complaints, Internal Investigations and other reportable matters*
- (5) Rule 3800, *Books and Records*; and
- (6) Rule 3900, *Supervision*

The above noted rules have been identified as requiring substantive revisions in order to:

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

Proposed Rule 3400 is a consolidation of the relevant requirements currently set out in IIROC Dealer Member Rules 1300, 2500, 2700, and 3200 that relate to suitability.

Proposed Rule 3500 contains relevant requirements currently set out in IIROC Dealer Member Rule 29 relating to sales practices.

Proposed Rule 3600 is a consolidation of the relevant requirements currently set out in IIROC Dealer Member Rules 29 and 3400 that relate to communications with the public.



Proposed Rule 3700 is a consolidation of the relevant requirements currently set out in IIROC Dealer Member Rules 2500, 2700, and 3100 that relate to complaints and internal investigations.

Proposed Rule 3800 is a consolidation of the relevant requirements currently set out in IIROC Dealer Member Rules 17 and 200 that relate to books and records.

Proposed Rule 3900 is a consolidation of the relevant requirements currently set out in IIROC Dealer Member Rules 18, 38, 1300, 1800, 1900, 2400, 2500, 2600, 2700, and 3200 that relate to supervision.

Issues and specific proposed amendments

Current rules

Other than the proposed substantive revisions set out below, the proposed Rules do not create any new obligations for Dealer Members and have been drafted to clarify the existing Rules with respect to dealings with clients.

Proposed rules

In addition to the plain language rewrite of the existing requirements to create proposed Rule 3400, “*Suitability*”, the following substantive amendments are proposed:

- *Suitability of orders and recommendations*: Current IIROC Dealer Member Rules require that each Dealer Member use due diligence to ensure that any order accepted from a client and any recommendation made to a client is suitable for the client. The obligation to ensure that orders and recommendations are suitable includes not only an obligation to ensure that the specific security is suitable for the client but also that the order type, along with the trading strategy recommended and/or adopted, as well as the account type, are also suitable for the client. As an example, the risk profile of a client who fully pays for a position in a specific security as a core long term holding is significantly different from the risk profile of a client buying the same security on margin, as part of a day trading strategy. For consistency with current IIROC expectations and Dealer Member practices, proposed Rule 3400 will clarify that in order to ensure suitability of an order or recommendation, the Dealer Member must also consider the suitability of the account type, trading strategy, order type and the method of financing the trade. [3402(2)]



- *Suitability determination not required*: Current Dealer Member Rule 2700, Part I (4) requires written waivers from permitted clients as defined in National Instrument 31-103 for the suitability requirement to not apply. The proposed clause 3405(1)(iii) will not require a waiver for any client that is a regulated entity as defined in Corporation Rules. This change is proposed so foreign entities that are the equivalent of Dealer Members will not require written waivers. [3405(1)(iii)]

In addition to the plain language rewrite of the existing requirements to create proposed Rule 3500, “*Sale practices*”, the following substantive amendments are proposed:

- *Service fees* - Current IIROC Dealer Member Rules require that each Dealer Member provide clients with a service fee schedule upon account opening and 60 days prior notice of any change to the service fee schedule. In order to codify current IIROC expectation and Dealer Member practices, proposed Rule 3500 will clarify that Dealer Members will not be subject to the above noted requirement when dealing with Institutional Clients. [3506(3)]
- *Commission fees and advisory fees* - Unlike the requirement for Dealer Members to provide a service fee schedule to their clients, the current Dealer Member Rules do not require Dealer Members to provide a commission fee schedule to their clients. For consistency with the requirement to provide a service fee schedule, proposed Rule 3500 will require Dealer Members to provide a commission fee schedule, or schedule of other advisory fees where applicable, to their clients upon account opening or 60 days prior notice of any change to the commission charge. An advisory fee schedule would include a notice of any fees applicable to fee based accounts. The requirement to provide a commission fee schedule will only be applicable where the Dealer Member charges a fixed (dollar or percentage) commission fee. Dealer Members will not be subject to the above noted requirement when dealing with Institutional Clients. [3505]
- *Inside information* - The current Dealer Member Rules state that any employee or Approved Person of a Dealer Member acting as a Director of a public issuer, in an underwriting or advisory capacity to a public issuer, has a fiduciary obligation not to reveal any privileged information to anyone not authorized to receive it



until there has been full public disclosure of such information. For consistency with securities legislation, proposed Rule 3500 will be amended as follows:

- *Fiduciary obligation*: The reference to fiduciary obligation has been omitted from the proposed rule. For consistency with securities legislation, the relationship has been categorized as a *special relationship* in the proposed Rule.
- *Privileged information*: The reference to privileged information has been omitted. For consistency with securities legislation, the information has been categorized as *material non-public information* in the proposed Rule; material non-public information refers to any material fact or material change that has not been generally disclosed.
- *Recipient of information*: The existing Dealer Member Rule prohibits the disclosure of privileged information to anyone not authorized to receive it. For consistency with securities legislation, the proposed Rule will state that the information can not be disclosed to anyone *unless in the necessary course of business*.

Based on the above noted changes, proposed Rule 3500 will clarify that any Approved Person, employee or agent of a Dealer Member who acts as a director to a public issuer, or in an underwriting or advisor capacity to a public issuer, is a person in a special relationship with the issuer and must not disclose any material non-public information about the issuer to any one, including any employees, agents or clients of the Dealer Member unless that disclosure is made in the necessary course of business. Proposed Rule 3500 will also clarify that when a Dealer Member, Approved Person, employee or agent of a Dealer Member has material non-public information about an issuer and discloses it to another Approved Person, employee or agent of the Dealer Member in the necessary course of business, then that person also becomes a person in a special relationship with the issuer and must not disclose any material non-public information about the issuer, unless in the necessary course of business.
[3507(1) through (3)]

In addition to the plain language rewrite of the existing requirements to create proposed Rule 3600, “*Communication with the public*”, the following substantive amendments are proposed:



- *Scope of obligations* - Proposed section 3602 which deals with advertising requirements speaks only to the Dealer Member's minimum obligations and does not make reference to the obligations of Approved Persons in communicating with clients. The underlying expectation is that Dealer Members will ensure that their Approved Persons comply with the Rule. The proposed plain language Rules will include a separate introductory section which will clarify that Rules applicable to Dealer Members will also equally apply to Approved Persons, to the extent relevant. [3602]
- *Guideline*- The current IIROC Dealer Member Rule 3400 includes guidelines as to best practices in developing policies and procedures on research reports. The parts of Rule 3400 that are guidelines, rather than rules, have been removed and included in a Guidance Note accompanying the proposed new Rule 3600.
- *Approval of policies and procedures*- The proposed Rule will no longer require Dealer Member policies and procedures on client communications and analyst conflicts of interest to be approved by and filed with IIROC, however, Dealer Member policies and procedures will continue to be subject to the regular compliance review process.
- *Record retention period*: Current Dealer Member Rule 29.7(5) requires the retention of copies of all advertisements, sales literature, correspondence, and records of supervision for a period of 2 years from the date of creation in the case of advertisements, sales literature and related documents, and a period of 5 years from the date of creation in the case of all correspondence. Proposed Rule 3602(7) removes the retention periods specified in the current rule and refers instead to the retention periods set out in Rule 3800, Business Records and Client Communications. Specifically, section 3802 changes the retention period for advertising related materials to 7 years. [3602(7)]

In addition to the plain language rewrite of the existing requirements to create proposed Rule 3700, "*Reporting and handling of Complaints, Internal Investigations and other reportable matters*" the following substantive amendments are proposed:

- *Prohibition of release restrictions* - The proposed Rule relating to the prohibition of release restrictions has been extended to apply to releases entered into involving Institutional Clients. [3711(1)]



In addition to the plain language rewrite of the existing requirements to create proposed Rule 3800, “*Books and Records*”, the following substantive amendments are proposed:

- *References to specific derivatives in ledger accounts and client account statements*- Proposed Rule 3800 replaces the terms "commodity futures contracts" and "commodity futures contract options" with the term "derivatives", unless specific references to those terms are necessary to clarify reporting requirements such as in trade confirmations. This revision allows the ledger and client statement requirements to be extended to other derivatives and will create consistency in the books, records and reporting being maintained. *[throughout 3800]*
- *Replacement of the term "securities"*- Proposed Rule 3800 replaces the term "securities" with the term "investment products". The current language assumes that all account positions received into and /or delivered out of the accounts are securities. Since Dealer Members transact in investment products, including securities, derivatives and certain deposit instruments, the proposed Rule has been amended to refer to investment products instead of securities. This revision allows the books, records and reporting requirements to be extended to all investment products. *[throughout 3800]*
- *Replacement of the term "exchange"* - Proposed Rule 3800 replaces the term "exchange" with the term "marketplace". This revision allows the requirements in Rule 3800 to be extended to all marketplaces, not only exchanges. *[throughout 3800]*
- *Record retention requirements*- The proposed Rule sets out the general requirements for retaining records under Corporation Rules and other relevant legislation. The provision is drafted to comply with NI 31-103 which requires records to be kept for a period of seven years from the date the record is created. Guidance Note 3800-2 *Content and retention of books and records* outlines the records that must be kept under NI 31-103. In addition, there are other relevant pieces of legislation relating to limitation periods, including securities legislation, provincial securities and commodities acts, federal and provincial corporations acts, etc., which may contain retention periods which differ from the seven year general limitation period. If Corporation Rules or securities legislation relating to



the specific type of record requires a retention period other than the seven year limitation, then it is acceptable to conform to those specific requirements. The proposed Rule ensures consistency with other Dealer Member Rules as well as other applicable securities legislation. [3802]

- *Removal of the Board of Directors approval of the statistical information requested of a Dealer Member with respect to their business* - The proposed Rule relating to statistical information provided by Dealer Members has been rewritten to eliminate the approval of the Board of Directors. The Corporation will retain the ability to require Dealer Members to provide statistical information. [3805(4)]
- *Opening and closing transactions requirement for blotter, record of order received and trade confirmations* - The proposed Rule will specifically require opening or closing transactions (where required by the marketplace) to be shown on blotters, record orders and trade confirmations. Transactions that do not identify whether it is an opening or closing transaction can significantly complicate the risk management process of the clearing house since it becomes difficult to identify and match up positions. Proposed Rule 3800 will clarify this issue and improve market efficiency by explicitly stating that an opening or closing transaction must be shown if it is required by the marketplace in which the trade took place. [3806(1)(xi)]
- *Requirements for blotters (records of original entry)* - The current requirements for maintaining blotters and other records of original entry isolate prescriptive items for a few individual types of investment products. Proposed Rule 3800 includes minimum blotter requirements that Dealer Members will be required to maintain. This revision was made to ensure consistency in the books and records being maintained for all transactions. Moreover, the reporting items for blotters relating to trades in specific debt securities and derivatives are moved into Guidance Note 3800-2. [3806]
- *Record of orders received* - The current IIROC Dealer Member rules specify that each record of order or other instruction must show the time of execution or cancellation. However, the current rules do not explicitly require that time of modification be reported. The proposed Rule expands upon this requirement by including the time of modification. This revision is intended to provide greater



transparency in the Dealer Member's reporting obligations. [3812(2)(vi) and (vii)]

- *Marketplace disclosure requirement* - Currently, Dealer Member Rule 200 requires written trade confirmations to disclose the exchange upon which a trade took place. This requirement does not capture trades executed outside of recognized exchange facilities such as quotation and trade reporting systems and alternative trading systems, as well as circumstances in which trades are executed on more than one marketplace. The proposed Rule will account for all marketplaces and for trades that are executed on more than one of these marketplaces. [3831(1)(iii)]
- *Requirements for client account statements* - Proposed Rule 3800 clarifies IIROC's expectation that a Dealer Member must provide certain minimum information on an account statement to clients. The current requirements do not explicitly list the information that must be listed on an account statement for all transactions involving investment product positions held by or controlled by the Dealer Member for the client. The proposed Rule has been written taking into consideration the requirements set out in Section 14.14, "Client statements", of National Instrument 31-103. [3841]
- *Consolidated statements* - The current Dealer Member Rules specify the minimum disclosure to clients, such as requiring a Dealer Member to send out monthly or quarterly client statements; however the rules are not clear with respect to the reporting requirements when reporting on a consolidated basis. The proposed Rule adds a new section which incorporates the information set out in a guidance notice issued on August 2, 2001 (IDA MR-0087) regarding consolidated statements. Pursuant to the proposed Rule, a Dealer Member may provide consolidated statements to clients in addition to, but not in place of, the statements required under Corporation Rules. The proposed Rule requires that the consolidated statement clearly state: i) the positions covered by CIPF; ii) the legal entity to contact regarding statement errors; and iii) that the legal entity statement is the statement that is subject to annual auditor confirmation. [3842]

In addition to the plain language rewrite of the existing requirements to create proposed Rule 3900 *Supervision*, the following substantive amendments are proposed:



- *Organization of Supervision Rules* - The Rules relating to supervision of a Dealer Member's business have been reorganized to clearly distinguish between supervision requirements that apply to all types of businesses and those that only apply to specific types of business, such as retail, institutional, managed accounts, or order-execution only. [throughout 3900]
- *Review Criteria and Trade Thresholds* - Existing Dealer Member Rule 2500 contains many provisions relating to the criteria for account review and trade thresholds that are intended as guidance only. These provisions have been removed from the proposed Rule, with the sections that continue to be relevant moved into guidance notes attached to proposed Rule 3900.
- *Alternate Designated Supervisors* - In the proposed Rule, the requirement for Dealer Members to appoint alternate designated Supervisors has been included in Part B General Requirements for Account Supervision, ensuring that this requirement is applied uniformly across all business activities. In addition, the requirement for alternate designated Supervisors to be specifically appointed for options accounts and for futures accounts has been included in this part of the proposed Rule. This clarifies the rule that alternate designated Supervisors are required for all options and futures business, both institutional and retail. The current Rules only state this requirement explicitly for retail accounts. [3900, Part B]

The full text of the proposed plain language Rules 3400 to 3900 are attached.

Rule-making process

IIROC Staff involved representatives of Dealer Members in the rule development process, through preliminary consultations.

Proposed Rules 3400, 3500, 3600, 3700, 3800 and 3900 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 Rules 3400, 3500, 3600 and 3900. Copies of these proposed Rules were then made available to all CLS Members for their input and comments. A copy of the proposed Rule 3800 was made available to the Financial Administrators Section ("FAS"). Proposed Rule 3800 was also submitted to the FAS Executive committee and the FAS Operations Subcommittee for review 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 June 24, 2010.

The text of proposed plain language Rules 3400 to 3900 is set out in Attachment A. The text of the existing Dealer Member Rules to be repealed is set out in Attachment B. A table of concordance is included as Attachment C. The text of the relevant Guidance Notes is set out in Attachment D. The attached Guidance Notes are based on previously issued guidance and/or notices.

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.

With respect to proposed Rule 3600 (Communications with the Public), IIROC staff had received requests from Dealer Members to consider amending existing Dealer Member Rule 3400 (Research Restrictions and Disclosure Requirements) so that IIROC requirements are consistent with those in place in the United States. This issue has become more of a focal point recently with the publication of proposed amendments to the FINRA requirements on research analysts and research reports outlined in FINRA Regulatory Notice 08-55. IIROC staff intend to consider other potential amendments to the research rules as a separate project. We have consulted with FINRA on their proposed rule changes and have been advised that some aspects of their proposed amendments may be revised before they are finalized. In any case, we expect that any project involving significant changes to the research requirements will require considerable input and discussion. The amendments will be considered as part of 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;
- Foster fair, equitable and ethical business standards and practices; and
- Promote the protection of investors.

IIROC staff propose that rules pertaining to dealing with clients 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 3400 to 3900, Dealer Members will benefit from enhanced clarity and certainty in the proposed Rules.

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 3400 to 3900 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:

Brendan Hart

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A second copy should be addressed to the attention of:

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

Questions may be referred to:

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Attachments

Attachment A

Proposed Rule 3400
Proposed Rule 3500
Proposed Rule 3600
Proposed Rule 3700
Proposed Rule 3800
Proposed Rule 3900

Attachment B Text of the relevant provisions of existing Dealer Member Rules

Attachment C Table of Concordance

Attachment D

Draft Guidance Note 3400-1
Draft Guidance Note 3500-1
Draft Guidance Note 3500-2
Draft Guidance Note 3500-3
Draft Guidance Note 3500-4
Draft Guidance Note 3600-1
Draft Guidance Note 3600-2
Draft Guidance Note 3600-3
Draft Guidance Note 3700-1
Draft Guidance Note 3700-2
Draft Guidance Note 3700-3
Draft Guidance Note 3800-1
Draft Guidance Note 3800-2
Draft Guidance Note 3800-3
Draft Guidance Note 3900-1
Draft Guidance Note 3900-2
Draft Guidance Note 3900-3