IIROC OCRCVM
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

Please distribute internally to:

Institutional
Internal Audit
Legal and Compliance
Operations
Retail
Senior Management
Trading desk
Training

Contact:
Brendan Hart
Policy Counsel, Member Regulation Policy
416 865-3047
bhart@iiroc.ca

11-0061
February 11, 2011

Plain language rule re-write project – Dealer Member Organization and Registration Rules – Proposed Rules 2100 - 2700

Summary of the nature and purpose of the proposed Rule

On April 30, 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 2100 through 2700 relating to Dealer Member organization and registration (collectively, 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 substantive change rules:

(1) Rule 2100, *Ownership of a Dealer Member's Securities*;

(2) Rule 2150, *Dealer Member Structure*;

(3) Rule 2200, *Dealer Member Membership Changes*; and

(4) Rule 2450, *Acceptable Back Office Arrangements*.

The existing rules relating to ownership, structure, IIROC membership, and back office arrangements of Dealer Members 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 legislation.

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 Dealer Member organization and registration.

Proposed Rules

In addition to the plain language rewrite of the existing requirements to create the Proposed Rules, the following substantive amendments are proposed:

- *Issuing certain types of securities*: Existing Dealer Member Rule 5.2 requires Dealer Members to obtain IIROC approval before issuing subordinated debt, restrictive securities, and limited participation securities. In the case of issuances of restrictive and limited participation securities, IIROC only has a regulatory interest where the issuances result in a change in Dealer Member ownership percentages and/or the acquisition of a significant equity interest. Since changes in ownership percentages and/or the acquisition of a significant equity interest already require approval under a separate existing rule (as well as a separate proposed plain language rule), the requirement to approve issuances of restrictive and limited participation securities has been repealed. *[2102]*
- *Delegates of District Council*: The proposed Rules 2100 and 2150 relating to ownership of a Dealer Member's securities and structure of a Dealer Member have been rewritten to allow for delegation of some of the District Council's authority. This was done to reflect existing practice and to make the proposed Rules consistent with other Corporation Rules that allow for District Councils to delegate authority for certain functions to subcommittees of the District Council or to IIROC staff. *[2107-2109, 2116, 2154, 2156]*

- *Prospectuses and underwriting of Dealer Member issues*: Existing Dealer Member Rule 5.9 requires Dealer Members to issue a prospectus and comply with securities laws when publicly distributing their own securities. It also allows Dealer Members to distribute their own securities by way of either an agency or bought deal, and either through another underwriter or itself as underwriter. This section is unnecessary and will be removed in proposed section 2110. All Dealer Members must comply with securities laws and issue a prospectus or alternative to a prospectus under those laws if distributing to the public. Also, Dealer Members are permitted to use any form of underwriting, as long as it complies with securities law, so it is unnecessary to enumerate the possibilities. The requirement in existing Rules 5.9 and 5.10 for Dealer Members to publish summaries of at least two independent valuations if they are underwriting more than 25% of their own issue, or are issuing through another underwriter on an agency basis, will be retained. This requirement is necessary to address conflict issues that may arise when a Dealer Member underwrites its own issues or issues through another underwriter as agent. *[2110]*
- *Private sales*: Existing Dealer Member Rule 5.11 allows private sales of Dealer Member securities, so long as they are not sold publicly until a prospectus is filed in accordance with securities laws. It also indicates that after a prospectus is filed, the Dealer Member must comply with continuous disclosure requirements under securities laws. The Rule indicates that the Dealer Member must satisfy its District Council that arrangements have been made to preclude the development of a public trading market in the securities. This Rule is unnecessary, since all Dealer Members must file a prospectus under applicable securities laws before its securities are publicly traded, and then they also must comply with continuous disclosure requirements. This section will therefore be removed. *[2100]*
- *Take-over bids and amalgamations*: Dealer Member Rule 5.12(a) indicates that a Dealer Member may distribute securities through a take-over bid or amalgamation, but that it must satisfy its District Council as to:

  " (i) The stage in the transaction at which prospectus-type information will be provided;

  (ii) The securities commission that will be responsible for reviewing and commenting on the information;

  (iii) The persons to whom the prospectus or similar document will be distributed;

  (iv) The rescission or withdrawal rights to be made available if the document contains a material inaccuracy"

  Dealer Members must provide information as required in securities laws and regulation, so these requirements are duplicative. Additionally, it is inappropriate that IIROC pass judgment on which securities commission is reviewing documentation. Furthermore, withdrawal and rescissions rights are included in securities legislation. For these reasons,

this section will be removed from the plain language rewrite of this rule. The requirement that valuations be obtained in non-arm's length transactions will be retained. *[2111]*

- *Compliance with securities legislation or regulations*: Dealer Member Rule 5.16A provides that the provisions of Rules 5.9 to 5.16 do not apply if a Dealer Member's activity is in compliance with any securities legislation or regulation that specifically addresses the activity in question. With the removal of rules that overlap with securities legislation and regulation as contemplated above, this provision will no longer be required and will be removed. *[2100]*
- *Related companies and associates*: Existing Dealer Member Rule 6.3 requires that a Dealer Member, or an executive, director, investor, or employee of a Dealer Member, obtain District Council approval before investing in related companies or associates. In proposed section 2154, the requirement for approval prior to investing in associates has been removed. Investment in other entities is only relevant to IIROC if it is in another broker dealer or adviser, and the requirement to obtain approval for this has been retained. *[2154]*
- *Confidentiality of client information*: In proposed Rule 2157(13), the provisions relating to confidentiality of client information in shared premises have been amended so as not to duplicate federal and provincial privacy legislation. *[2157]*
- *Reasons for resigning*: In existing Dealer Member Rule 8.2, Dealer Members are required to provide the reasons for their resignation. In proposed Rule section 2203, this requirement has been removed. IIROC's primary concern is ensuring that clients are properly protected in the event of a resignation. Provided a Dealer Member fulfills the other requirements of resignation, including providing audited financial statements that show the Dealer Member is able to meet its liabilities, IIROC is not primarily concerned with the reasons for the resignation. Therefore this requirement was determined to be unnecessary. *[2203]*
- *Representations on acquisition or amalgamation of Dealer Members*: Currently, Dealer Member Rules 8.3 and 8.3A require that, upon the acquisition of a Dealer Member by another Dealer Member, or amalgamation of Dealer Members, the remaining Dealer Members must certify that they have sufficient liquid assets to meet all the liabilities, other than subordinated loans. Current Dealer Member Rule 17.1 also requires all Dealer Members maintain adequate risk adjusted capital (based on comparing liquid assets to liabilities) at all times. This would include Dealer Members that remain after acquisition and amalgamation transactions. The separate certification requirements in Rules 8.3 and 8.3A are therefore redundant and have been removed from sections 2204 (Acquisitions) and 2205 (Amalgamations). IIROC normally requires pro forma financial statements in acquisitions and amalgamations of Dealer Members, and this has been codified in the proposed Rule. *[2204-2206]*

- *Effective date of resignation*: Dealer Member Rule 8.5 currently indicates that a resignation will take effect on the "close of business" on the day that IIROC determines the resigning Dealer has met the requirements of the resignation rules. This wording has been removed in proposed Rule 2207, as it is unnecessarily specific. Also, a requirement that IIROC publish a notice indicating the effective date of resignation of a Dealer Member has been added. It has historically been the practice of IIROC to publish a notice indicating the effective date of resignations, and this practice is being formalized in the rule. *[2207]*

- *Suspension and termination of membership*: Dealer Member Rule 8.8 currently allows for termination of the membership of a Dealer Member if the Dealer Member has ceased its activities in the securities business or has been acquired by a non-member. Before a termination can take place, the Dealer Member must be given the opportunity for a hearing in accordance with the Consolidated Enforcement Rules (currently contained in Dealer Member Rule 20) and the applicable District Council must approve the termination. Proposed Rules 2210 and 2211 seek to:
  - broaden the scope of this rule to include the ability to suspend members; and
  - require IIROC approval (rather than District Council approval) of the termination / suspension.

  The proposed rules will continue to give the affected Dealer Member the opportunity for a hearing in accordance with the Consolidated Enforcement Rules. *[2210-2211]*

- *New defined terms*: Current Dealer Member Rule 35 does not include definitions for the terms "Canadian registered firm", "introducing broker / carrying broker arrangement" and "clearing arrangement". Definitions for these terms have been added to codify current guidance as to which back office sharing arrangements are acceptable to IIROC and which activities performed collectively comprise an introducing broker / carrying broker arrangement and a clearing arrangement. *[2460(2) though (4)]*

- *New restriction on Type 3 and 4 introducing brokers:* When the rules for introducing broker / carrying broker arrangements were originally developed, the intention was that the client accounts of the introducing broker would all be reported on one of the arrangement broker's book – either those of the introducing broker or the carrying broker. The current rule wording, however, does not specifically prohibit a Dealer Member from entering into a Type 3 or 4 introducing broker / carrying broker arrangement and then subsequently entering into a Type 1 or 2 introducing broker / carrying broker arrangement. This prohibition has now been added to the proposed rule. *[2473(1)(iv)]*

- *Arrangement approval streamlining:* The following are the current approval processes that apply to various arrangements:

Arrangement type	**Approval process**
Introducing broker / carrying broker arrangement between two Dealer Members	Applicable District Council approval [Rule 35.1(b)]
Introducing broker / carrying broker arrangement between Dealer Member and foreign affiliated dealer	Applicable District Council approval of exemption application [Rule 35.6]
Clearing arrangement between Dealer Member and foreign affiliated dealer	Applicable District Council approval of exemption application [Rule 35.1(h) or 35.6]
Clearing arrangement between Dealer Member and domestic affiliated dealer / arms-length dealer	Board of Director approval for exemption from all requirements [Rule 35.1(h)]

  The proposed rule:

  - adopts one process for the approval of introducing broker / carrying broker arrangements, IIROC approval; and
  - exempts other arrangements, such as certain clearing arrangements, from requiring IIROC approval.

  [2474(1)(i), 2474(1)(iv), 2485(1)(iii) and 2491(1)]

- *Margin requirements to be provided by the carrying broker:* The current rule indicates that margin must be provided by the carrying broker for introducing broker unsettled principal trading positions but does not specify how the margin requirement is to be calculated. The proposed rule clarifies that the carrying broker must provide margin on any introducing broker unsettled principal trading positions on an equity deficiency basis. This clarification is consistent with the normal margin treatment of inter-dealer balances. *[2475(3)(i), 2476(3)(i), 2477(3)(i) and 2478(3)(i)]*

- *Deposits provided to the carrying broker by the introducing broker:* The proposed rule clarifies that deposits provided by the introducing broker to the carrying broker must be reported by the carrying broker as a liability on its Form 1 and MFR. This reflects current practice and Canadian GAAP. The requirements wording for Type 3 and 4 Arrangements has also been conformed to the wording of the current requirements for Type 1 and 2 Arrangements. *[2475(7)(i), 2476(7)(i), 2477(7) and 2478(7)]*

- *Insurance coverage requirements of the introducing broker:* The proposed rule clarifies that the client net equity of introduced accounts must be considered by Type 1 and 2 introducing brokers when determining adequacy of insurance coverage. This is consistent with the insurance coverage requirements set out in Dealer Member Rule 400. *[2475(11)(i), 2476(11)(i)]*

- *Clients introduced to the carrying broker:* The proposed rule clarifies that introduced clients are considered to be clients of both the introducing broker and the carrying broker since the services provided to the client, and related obligations, are split between two dealers. Specifically, each dealer must be accountable, and must comply with the applicable IIROC rules, for the services they provide to and obligations they undertake for the client. In addition, the introducing broker must ensure the client is properly served, irrespective of which dealer is providing the particular service. This is consistent with current rule application guidance. *[2475(16)(i), 2476(16)(i), 2477(16)(i) and 2478(16)(i)]*
- *Handling client cash:* The proposed rule amends the cash handling requirements for Type 2 Arrangements to prohibit the introducing broker from handling client cash in the form of money and to require that any cheques provided to the introducing broker be in the name of the carrying broker. These amendments reflect industry practice for Type 2 Arrangements and are necessary as the introducing broker does not have the same processes/facilities for handling cash as the carrying broker. *[2476(18)]*
- *Offsets of carrying broker margin requirements against deposits:* The proposed rule introduces a requirement for Type 3 and 4 Arrangements that the carrying broker notify the introducing broker when a portion of any deposit amount is used. This is consistent with the current requirements for Type 1 and 2 Arrangements and is necessary to enable the introducing broker to properly classify its deposit assets as either allowable or non-allowable. *[2477(4)(i) and 2478(4)(i)]*
- *Arrangements that may be executed with a foreign affiliate:* The proposed rule introduces a new section outlining the general requirements that must be met in order for a Dealer Member to carry client accounts of a foreign affiliate dealer. The general requirements are consistent with those that apply to an introducing broker / carrying broker arrangement between two Dealer Members. *[2485(1)]*
- *Permitted arrangements not considered to be introducing broker / carrying broker arrangements:* The proposed rule specifically states that certain clearing arrangements are not considered to be introducing broker / carrying broker arrangements. As a result, qualifying clearing arrangements will no longer be subject to specific IIROC conditions / requirements / approval. *[2491(1)]*
- *Prohibited arrangements:* The proposed rule specifically prohibits entering into introduction arrangements other than with another Dealer Member or with a foreign affiliate dealer. *[2495(1)]*

Rule-making process

IIROC Staff involved representatives of Dealer Members in the rule development process, through preliminary consultations. The Proposed Rules were made available to all Dealer Members for their

input through a Dealer Members-only website. IIROC's National Advisory Committee was asked for their input on the substantive amendments to proposed 2100 and 2150.

The Proposed Rules were approved for publication by the IIROC Board of Directors on April 30, 2010.

The full text of the Proposed Rules 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.

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.

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 Dealer Member organization and registration be rewritten to reflect actual IIROC expectations, to enhance the clarity of the rules 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 Rules, Dealer Members will benefit from enhanced clarity and certainty in rules relating to organization and registration 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 2100 through 2700 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
Policy Counsel
Investment Industry Regulatory Organization of Canada
Suite 1600, 121 King Street West
Toronto, Ontario
M5H 3T9
bhart@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:

Brendan Hart
Policy Counsel, Member Regulation Policy
Investment Industry Regulatory Organization of Canada
416-865-3047
bhart@iiroc.ca

Attachments

Attachment A - Proposed Rules 2100 - 2700

Attachment B - Text of the relevant provisions of Dealer Member Rules 4, 5, 6, 7, 8, 17, 18, 22, 29, 31, 35, 38, 39, 40, 100, 500, 600, 700, 1300, 2400, 2900, and 3200

Attachment C - Table of Concordance

Attachment D - Guidance Notes relating to Proposed Rules 2100 – 2700