

IIROC NOTICE

Rules Notice **Guidance Note** Dealer Member Rules

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Contact:
Richard J. Corner
Vice President, Member Regulation Policy
416-943-6908
rcorner@iroc.ca

Joe Yassi
Vice President, Business Conduct Compliance
416-943-6903
jyassi@iroc.ca

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Recommendations and best practices for distribution of non-arm's length investment products

Overview

The distribution, by an IIROC Dealer Member to its clients, of investment products of an issuer that does not deal at arm's length with the Dealer Member raises potential regulatory and investor protection concerns. There have been at least four instances in recent years where clients of IIROC Dealer Members have lost money as a result of investing in non-arm's length investment products, being Essex Capital Management Limited, iForum Securities Inc., Graydon Elliott Capital Corporation and First Leaside Securities Inc. There have been other similar circumstances involving securities dealers, mutual fund dealers and other distributors in Canada, the United States and elsewhere. At the core of the concerns identified is the fact that when a Dealer Member and an issuer are related, conflicts of interest may arise. Where conflicts of interest exist, potentially exist, or are perceived to exist, it becomes more difficult for the Dealer Member to meet its legal and regulatory obligations to its clients. These obligations to protect the client include the duty to satisfy the high standards of conduct expected of an IIROC Dealer Member pursuant to Dealer Member Rule 29.1 and to comply with other specific and general Dealer Member Rule provisions relating to suitability and conflicts of interest. The wide variety of possible fact situations that could



create a conflict of interest results in different legal and regulatory obligations depending on the standard of care owing to the client in each set of facts.

The investment products covered in this Guidance Note are generally referred to for convenience as "non-arm's length" products and are intended to include products issued by:

- the Dealer Member itself,
- an issuer or a selling securityholder, with which a Dealer Member does not deal at arm's length, or
- an issuer or a selling securityholder which a Dealer Member is otherwise connected or related to.

A more detailed description of the "Investment products and issues covered by this Guidance Note" is included below.

IIROC's objectives

The purpose of this Guidance Note is to alert Dealer Members to the regulatory concerns inherent in the distribution of non-arm's length investment products to their clients, and to advise Dealer Members of IIROC's expectations of them when they are involved in this activity. The existing Dealer Member Rules and regulatory requirements, in combination with applicable securities legislation, are considered adequate to protect clients from the inappropriate sale of non-arm's length products. IIROC intends to increase its compliance monitoring of this product distribution by Dealer Members through targeted compliance reviews and/or regularly scheduled compliance examination visits.

Regulatory Issues

The regulatory issues that may arise when Dealer Members distribute non-arm's length investment products vary according to the particular circumstances and could include the following:

- **Conduct standards.** The possibility that Dealer Members and their personnel may fail to appreciate that the distribution of non-arm's length investment products to their clients raises more conduct-related issues that must be considered than in the case where "arm's length" investment products are distributed. In such cases, this may result in a Dealer Member's failure to fully comply with the high standards of conduct set out in Dealer Member Rules 29.1 and 42 and applicable securities legislation.
- **Issuer scrutiny and product review.** Dealer Members have a responsibility to use fulsome due diligence procedures to assess investment products, especially products that are not subject to rigorous scrutiny in the marketplace by way of a prospectus review, rating agency review, analyst reports or other third party intermediaries. The Dealer Member's obligations to assess an investment product's suitability and to identify and address conflicts of interest cannot be complied with unless the Dealer Member has carefully reviewed and vetted all investment products which the Dealer Member wishes to offer for sale to clients. In the case of non-arm's



length investment products, this scrutiny by a Dealer Member is particularly critical.

Best practices for product due diligence were issued by IIROC on March 23, 2009¹. The standards and requirements set out in that Guidance Note also pertain to the investment products addressed in this Guidance Note - with the caution that heightened scrutiny and discipline are expected in reviewing products of non-arm's length issuers. In the case of investment products distributed to the public by a Dealer Member or its holding company, Dealer Member Rules 5.9 to 5.13, inclusive, may apply as well as corresponding requirements in provincial securities legislation. These rules require the involvement of third parties such as a qualified independent underwriter, rating agency staff, analysts and other selling syndicate members, as applicable, in order to ensure that the distribution is subject to an objective review. In any distribution where such third party involvement is not mandated or otherwise applicable, Dealer Members should consider arranging for substitute review or enhanced measures to ensure that the appropriate due diligence is conducted and the appropriate level of disclosure and other requirements are satisfied.

- **Conflicts of interest.** When a Dealer Member has a direct or indirect interest (financial or otherwise) in the issuer whose investment products it is distributing, an inherent conflict of interest exists that must be addressed, pursuant to Dealer Member Rule 42, “in a fair, equitable and transparent manner, and considering the best interests of the client”². Where a conflict of interest cannot be addressed in this manner, the Dealer Member should avoid the conflict of interest by not distributing the investment product to the client.

Guidance on applying the conflict of interest management/disclosure requirements set out in Dealer Member Rule 42 was included as part of the Client Relationship Model (CRM) Guidance Note that was issued by IIROC on March 26, 2012³. The guidance set out in the CRM Guidance Note also pertains to the investment products addressed in this Guidance Note, with one exception relating to conflict of interest disclosure. Specifically, the CRM Guidance Note allows for the possibility that a conflict of interest situation need not be disclosed to the client “under the ‘reasonable client’ test ... where the Dealer Member has taken other steps to control the conflict of interest and has effectively ensured, with reasonable confidence, that the risk of loss to the client has been eliminated.” As we do not believe this risk can be eliminated in the case of distributions of non-arm’s length investment product, we would expect that the client would always be provided with adequate disclosure of this conflict of interest.

- **Suitability.** IIROC’s suitability rules are a cornerstone of investor protection. However, if there is an affiliation between the Dealer Member and the issuer, the resulting conflict of interest may make it difficult for the Dealer Member to objectively assess and advise its client in respect of the

¹ Rules Notice 09-0087, “*Best practices for product due diligence*”.

² This is the standard of care set out in Dealer Member Rule 42.2(2) that applies to conflict of interest situations involving an Approved Person and a client. A similar standard of care is set out in Dealer Member Rule 42.3(2) for conflict of interest situations involving a Dealer Member and a client.

³ Rules Notice 12-0108, “*Client Relationship Model - Guidance*”.



investment, compromising this cornerstone protection. Suitability assessments can only be made after the firm's investment product due diligence and conflict of interest management policies and procedures have been complied with. The fact that a Dealer Member is or may be related in some respect to the issuer, increases the burden on the Dealer Member to ensure that suitability determinations are made objectively and without improper influence resulting from the Dealer Member's direct or indirect interest in the transaction.

Guidance on complying with the existing suitability assessment requirements set out in Dealer Member Rules 1300.1(p) and (q) was issued by IIROC on March 26, 2012⁴. Guidance on complying with the new suitability assessment requirements that will come into force on March 26, 2013⁵ was included as part of the Client Relationship Model (CRM) Guidance Note that was issued by IIROC on March 26, 2012⁶. The guidance set out in these Guidance Notes also pertains to the investment products addressed in this Guidance Note.

- **Disclosure.** Full disclosure to a prospective investor of “the salient features and risks” of an investment product is important and is one of the core regulatory protections available to investors. In the case of non-arm's length products, the incentive to provide full and meaningful disclosure to an investor may be impaired. In all cases, the Dealer Member must ensure that the client receives full and complete disclosure of the features and risks associated with the investment product and the conflicts of interest associated with distributing the investment product on a non-arm's length basis. However, as previously noted, in some cases disclosure alone may not be sufficient to manage these conflicts of interest and, in these cases, the Dealer Member should not distribute the investment product to the client.

In cases involving the distribution of non-arm's length investment products, IIROC believes that in order for a Dealer Member to comply with the Rules relating to conduct standards, product due diligence, conflict of interest management and suitability assessment, enhanced disclosure to clients is required. The level and manner of this enhanced disclosure, other than as specifically required in the Dealer Member Rules or in securities legislation, is not prescribed but should be appropriate to the particular circumstances.

- **Protection Fund Coverage.** Canadian Investor Protection Fund (CIPF) coverage provides for the return of client assets in the event that an IIROC Dealer Member becomes insolvent. CIPF does not protect against market losses regardless of how they occur. This distinction is important to emphasize in the case of non-arm's length investment products held in a client account. In this instance, the client may mistakenly believe that they have CIPF coverage for market losses, if the losses arise due to the insolvency of the Dealer Member that is either:
 - the issuer of the non-arm's length investment product; or

⁴ Rules Notice 12-0109, “*Know your client and suitability - Guidance*”.

⁵ Rules Notice 12-0225, “*Client Relationship Model - Extension of implementation of the enhanced suitability assessment requirements prescribed by Dealer Member Rule 1300.1*”

⁶ Rules Notice 12-0108, “*Client Relationship Model - Guidance*”.



- An affiliate of the issuer of the non-arm's length investment product.

CIPF coverage does not apply to market losses in non-arm's length investment products that arise from the insolvency of an IIROC Dealer Member.

Investment products and issues covered by this Guidance Note

The investment products which this Guidance Note addresses are not restricted to particular issuers or product types. Any issuer or selling securityholder that does not deal at arm's length with a Dealer Member, or is the Dealer Member itself, is considered to be a non-arm's length issuer.

In addition, the method of distribution is not determinative of the general standards to be applied, therefore, public, private and exempt distributions are covered. Having said that, the most common types of issuers and investment products that may be subject to the additional considerations identified above include:

Issuers or selling securityholders:

- the Dealer Member itself
- any affiliate (i.e. parent, subsidiary or entity with common control) of the Dealer Member [IIROC Dealer Member Rule 1.1]
- associates (corporations, partnerships, trusts, etc) in which a person has an interest [IIROC General By-law No. 1, Section 1.1]
- related issuers [National Instrument 33-105 of the Canadian Securities Administrators (CSA)]
- connected issuers [National Instrument 33-105 of the CSA]
- entities (whether or not a securities dealer or advisor) in respect of which the Dealer Member has, or is subject to, an ownership interest as if they were related companies [IIROC Dealer Member Rule 1.1]

Investment products:

- debt, including promissory notes, principal protected notes and asset-backed products
- investment fund products (mutual funds, hedge funds, investment clubs etc.)
- equities
- "exempt" products such as limited partnership units, real estate ownership interests, and commodity-based products including those where the non-arm's length issuer is the counterparty on the contract.



Summary of IIROC's expectations of Dealer Members

Dealer Member obligations in respect of the distribution of non-arm's length products are summarized in the sequence of steps below.

Step 1 – Product due diligence

As is the case for all investment products that a Dealer Member intends to distribute, the Dealer Member and its sales representatives must thoroughly understand non-arm's length products, their investment features, risks and value.

- To gain a thorough understanding of each investment product, Dealer Members should be guided by IIROC Guidance Note 09-0087, “*Best practices for product due diligence*”.
- If, following a product due diligence review, the analysis indicates that the product:
 - would be unsuitable for any client, the Dealer Member should not distribute the product.
 - would be suitable for certain clients, the Dealer Member should undertake a specific conflict of interest analysis as described in Step 2 below.

Step 2 – Conflict of interest assessment⁷

Inherent in non-arm's length products is the potential for conflicts of interest between the Dealer Member and its clients generally, and between each Approved Person and his/her client:

- To properly address conflicts, the Dealer Member must first identify and understand the nature and extent of such conflicts of interest and assess whether they can be adequately addressed on behalf of their clients.
- If the Dealer Member is not satisfied such conflicts of interest can be adequately addressed for its client base, the conflict should be avoided and the product should not be sold to any client.⁸
- If the Member is satisfied that a conflict may be adequately addressed for some or all of its clients, then, for those clients where the conflict can be adequately addressed the Dealer Member may proceed to the perform the suitability assessment as described in Step 3 below.

⁷ IIROC recommends that Dealer Member policy and procedures, and related controls, for assessing conflicts of interest generally be informed by the guidance set out within IIROC Rules Notice 12-0108, “*Client Relationship Model - Guidance*” and National Instrument 31-103 Companion Policy, Part 13 Division 2.

⁸ Two conflict of interest assessment standards are set out in Dealer Member Rule 42, “*Conflicts of Interest*”. These standards require both the Dealer Member and the Approved Person to assess whether the conflicts of interest associated with recommending a transaction in a non-arm's length investment product can be adequately addressed.



Step 3 – Client specific suitability

Suitability assessments must be made in respect of client orders and recommendations⁹ pursuant to IIROC requirements.

- If a proposed trade to a particular client in respect of a non-arm's length investment product is considered to be unsuitable, the trade should not be completed.
- If a proposed trade to a particular client is considered to be suitable, the Dealer Member may complete the trade provided that the trade otherwise complies with applicable laws and IIROC Rules, and provided that any conflict of interest identified has been managed in accordance with the firm's policies and procedures.

IIROC examination expectations

In the course of carrying out compliance reviews of Dealer Members, IIROC Business Conduct Compliance examiners will focus on written policies and procedures, and underlying controls relating to the identification and review of non-arm's length investment products distributed by a Dealer Member to its clients, and the management of conflicts of interest. The Dealer Member will be expected to establish an evidentiary record of, amongst others:

- (i) details of the product due diligence review procedures performed and evidence of approvals;
- (ii) a general description of the investment product and plan of distribution;
- (iii) particulars of the principal business uses of the proceeds of distribution by the issuer, including transaction expenses and commissions;
- (iv) copies of any offering materials including advertisements and/or sales literature, as defined in Dealer Member Rule 29.7, used by the Dealer Member;
- (v) specific references to applicable securities laws relied upon by the Dealer Member in connection with the distribution, including copies of any legal opinions addressing compliance with applicable securities laws, if obtained;
- (vi) details of the nature and extent of the potential conflict of interest, the analysis underlying its proposed management and conclusions drawn;
- (vii) details of the proposed management of any conflicts of interest identified with related controls specified.

Any questions regarding IIROC's compliance examination expectations should be directed to IIROC's Business Conduct Compliance Manager assigned to a particular firm.

⁹ New suitability assessment standards are to come into force on March 26, 2013. These new standards will require that suitability assessments be performed at times other than when a trade is being recommended to a client or when the acceptance of a client order is being considered and will require that the suitability assessment also consider the client's investment time horizon and the current risk level and composition of the client's account investment portfolio. The new requirements coming into force were announced in Rules Notice 12-0107, "*Client Relationship Model - Implementation*". Guidance on complying with these new requirements was also issued on the same day as part of Rules Notice 12-0108, "*Client Relationship Model - Guidance*".