

# IIROC NOTICE

## **Rules Notice** **Request for Comment** Dealer Member Rules

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**Notice 13-0040**  
**February 6, 2013**

## **Summary of comments received on draft guidance note “Requirements and best practices for distribution of non-arm’s length investment products”**

On February 5, 2010, the Investment Industry Regulatory Organization of Canada (“IIROC”) issued a draft Guidance Note for public comment<sup>1</sup> setting out regulatory expectations relating to the distribution by a Dealer Member to its clients of investment products issued by:

- the Dealer Member itself; or
- an issuer or a selling security holder with which a Dealer Member does not deal at arm’s length, or
- an issuer or a selling security holder with which a Dealer Member is otherwise connected or related

[Guidance Note 13-0039](#) has been amended to address public comments received. The Guidance Note sets out IIROC staff’s expectations regarding best practices for distributions by Dealer

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<sup>1</sup> Rules Notice 10-0028, ‘Request for comments on draft “Requirements and Best Practices for distribution of non-arm’s length investment products”’.



Members of non-arm's length investment products and provides guidance to assist Dealer Members in meeting their regulatory obligations to their clients.

We received 8 comment letters in response to this request for public comment. The public comments received and IIROC's response to each comment are as follows:

**1. Should IIROC issue guidance for addressing conflicts of interest, suitability and investment product due diligence issues relating to the distribution of non-arm's length investment products?**

The responses to this question were mixed. Some commenters thought that additional guidance would clarify for Dealer Members how to address the unique conflicts of interest situations that arise. One commenter submitted that additional IIROC guidance in this area would be "somewhat redundant" and lead to confusion among Dealer Members. Three commenters submitted that the current requirements with respect to investment product due diligence, suitability and conflicts of interest meet the regulatory objectives of investor protection and therefore additional specific guidance for non-arm's length investment products was unnecessary. One commenter submitted that IIROC has not provided sufficient evidence for significantly expanding the current requirements and another commenter submitted that it was not clear that IIROC has considered why the current requirements are insufficient, or assessed the costs involved. On the other hand, one commenter submitted that a formal IIROC Dealer Member Rule on how to: identify non-arm's length investment products; perform adequate due diligence; assess conflicts and suitability, would be valuable.

**IIROC's response**

IIROC believes that it is appropriate and necessary to issue a Guidance Note on this subject. In recent years there have been at least four instances 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. Further, IIROC's recent review of New Product Due Diligence disclosed significant deficiencies to be addressed. IIROC also believes that there is value in providing guidance on how we believe conflicts of interest that arise from the distribution of non-arm's length investment products should be addressed, in light of the recently implemented principle-based provisions of IIROC's new conflicts of interest requirements<sup>2</sup>.

IIROC agrees with the submission that the guidance should not always prohibit the distribution to all clients where the Member cannot adequately address a conflict of interest for some clients. It may be that the conflict of interest can be managed so as to allow distribution to some clients, depending on the facts.

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<sup>2</sup> Dealer Member Rule 42, "Conflicts of Interest", was implemented on March 26, 2012 through the issuance of Rules Notice 12-0107, "Client Relationship Model - Implementation". An accompanying Guidance Note was also issued on the same day as Rules Notice 12-0108, "Client Relationship Model - Guidance".



**2. Is the proposed draft Guidance Note requirement to notify IIROC in advance of distributions of non-arm’s length investment products needed to enable IIROC to properly monitor such distributions?**

Five commenters indicated that the proposed requirement to notify IIROC in advance of distributions of non-arm’s length investment products was unnecessary; two commenters were supportive of the requirement. One commenter expressed concern that two tiers of dealers, one with an advance reporting obligation and one without, would result if certain investment products were exempted from the advance notification requirement. Seven commenters stated that this requirement should not be introduced through the issuance of a Guidance Note. One commenter encouraged IIROC to introduce this requirement through a formal rule amendment.

**IIROC’s response**

We agree with the commenters view, that this advance notification requirement, if adopted, should be introduced through the rule amendment process. IIROC has therefore removed the requirement from the Guidance Note and will consider whether a rule change relating to IIROC advance notification should be implemented. To determine whether a rule change is necessary IIROC intends to increase its compliance monitoring of the distribution of non-arm’s length investment products by Dealer Members through targeted compliance reviews and through its regularly scheduled compliance examination visits.

The concern that two tiers of dealers would be created is also addressed, as the removal of the advance notification requirement means that no dealers will have an advance reporting obligation.

**3. Should a Dealer Member perform additional product due diligence review procedures on all non-arm’s length investment products?**

One commenter submitted that there should be no difference in requirements for non-arm’s length investment products and that no additional due diligence was required. Two commenters submitted that an investment product due diligence review was not required where the affiliated entity issuing or sponsoring the investment product was regulated by another Canadian regulator.

**IIROC’s response**

IIROC’s investor protection mandate is not superseded by the fact that an affiliated entity may otherwise be regulated for prudential or other purposes. IIROC believes that conflicts of interest may arise when any non-arm’s investment product is to be recommended to a client. It is therefore important that additional steps be performed, as part of the firm’s written investment product due diligence policy and procedure, to identify, manage and address any such conflicts of interest.

If a conflict of interest is identified, the requirement under IIROC Dealer Member Rule 42 is that the conflict of interest must be addressed. It may not always be acceptable to address a conflict of interest situation through disclosure alone. In some cases it may be that the



conflict must be avoided, because it is prohibited by law or because it “cannot be addressed in a fair, equitable and transparent manner, and considering the best interests of the client”<sup>3</sup>.

**4. Should the Guidance Note provide guidance on acceptable disclosure for conflicts of interest?**

The three responses to this question each submitted that more definitive guidance was desirable. One response indicated that the Guidance Note should prescribe specific disclosures when a conflict is identified.

**IIROC’s response**

The regulatory obligation is to address all conflict of interest situations. This obligation can be met by providing prominent, specific, complete and meaningful disclosures in plain language so that the client will understand the conflict of interest, or, where the facts warrant, avoiding the conflict completely. While some specific conflict disclosures are addressed in IIROC Rules, IIROC believes that a principle-based approach is desirable, given the need for firms to have flexibility to identify the many types of conflict situations that may arise and to develop a meaningful response (i.e., conflict avoidance, disclosure and/or control) to address them.

**5. Guidance as opposed to rule making**

The commenters submitted that new substantive regulatory requirements should be subject to the rule-making approval process.

**IIROC’s response**

The Guidance Note proposed is not a new Rule, but rather, complements existing IIROC rule requirements relating to business conduct, conflicts of interest management and suitability assessment and is intended to assist Dealer Members to comply with such requirements. The guidance should be viewed as best practice recommendations for compliance policies, procedures and controls.

**6. Should the Guidance Note provide clarification as to whether Canadian Investor Protection Fund (“CIPF”) coverage applies to the distribution of non-arm’s length investment products?**

Five commenters answered in the affirmative, none opposed. The commenters submitted that clarification would benefit industry participants and investors.

**IIROC’s response**

The proposed Guidance Note includes clarification of the CIPF coverage applicable to non-arm’s length investment products.

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<sup>3</sup> This is the standard of care set out in IIROC 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 IIROC Dealer Member Rule 43.2(2) for conflict of interest situations involving an IIROC Dealer Member and a client.