

IIROC NOTICE

Rules Notice
Guidance Note
Dealer Member Rules

Please distribute internally to:

Internal Audit
Legal and Compliance
Operations
Regulatory Accounting
Senior Management

Contact:

Richard J. Corner
Vice President, Member Regulation Policy
(416) 943-6908
rcorner@iiroc.ca

14-0010
January 13, 2014

Clearing arrangements

While there are many back office sharing arrangements that may be entered into between two dealers, including “jitney” or omnibus arrangements, clearing arrangements, introducing broker / carrying broker arrangements and any other arrangement where one dealer provides certain back office services to another dealer, the current IIROC Dealer Member Rules focus mainly on those arrangements where individual client assets are held:

- in bulk at an external custodial location (including where client assets are held in custody by other dealers); or
- in separate fully-disclosed client accounts at one dealer as part of a back office service offering provided to another dealer;

As such is the case, there are specific rule requirements that must be met when securities are held by the Dealer Member at an external custodial location or held by a carrying broker on a fully-disclosed basis for an introducing broker. There are, however, no specific rule requirements to be met when securities are held pursuant to a “jitney” or omnibus account arrangement or other similar account arrangement at another dealer. What has been less clear to date is whether specific IIROC Dealer Member Rules apply to “clearing arrangements”.

In the past IIROC has taken the position that clearing arrangements were a form of introducing broker / carrying broker arrangement. As such, entering into a clearing arrangement could only be done by complying with the requirements set out in IIROC Dealer Member Rule 35. As part of a recent review of various back office sharing arrangements, IIROC has reconsidered this previous position and has determined that a clearing arrangement, as described in this Guidance Note, is not a type of introducing carrying broker arrangement and, as a result, entering into a clearing



arrangement does not require compliance with the requirements set out in IIROC Dealer Member Rule 35.

This Guidance Note explains:

- what a clearing arrangement is;
- why the requirements of IIROC Dealer Rule 35 do not apply to clearing arrangements; and
- the specific, practical issues and outsourcing due diligence obligations that should be addressed when considering whether to enter into a clearing arrangement.

1. What is a clearing arrangement?

A clearing arrangement is an agreement between two dealers, in which back-office services are outsourced from one dealer to the other dealer and, more specifically, where the primary purpose is the clearing and settlement of trades by one dealer for the other dealer. Such arrangements are common where a dealer doesn't have access to the capital markets in a particular jurisdiction but wishes to transact in the securities of that particular jurisdiction for its clients and/or for its own account.

To facilitate this arrangement, the clearing dealer opens up separate delivery against payment / receipt against payment (DAP/RAP) accounts for the outsourcing dealer and each of the outsourcing dealer's clients that wish to participate in the arrangement. In the case of client accounts, these accounts are opened up in the name of each client and represent separate accounts on the books of the clearing broker. The clearing dealer opens up individual accounts for each client, since, by necessity in order to ensure that client trades are properly settled and delivered to the correct custodian, each client must inform the clearing dealer of its identity and the identity of its settlement agent custodian. Executed trades are then settled by the clearing dealer by:

- in the case of a client purchase transaction, receiving in the settlement payment from the client's settlement agent and delivering out the purchased securities to the client's settlement agent; and
- in the case of a client sale transaction, receiving in the securities to be sold from the client's settlement agent and delivering out the settlement proceeds to the client's settlement agent

In summary, the services provided by the clearing dealer under a clearing arrangement are:

- trade execution services (in most cases);
- trade clearing and settlement services; and
- maintenance of individual clearing client account records, detailing the settlement of purchase and sale transactions within each client's DAP/RAP account and the delivery-out and receipt-in of security and investment product positions relating to these transactions.



2. What services are not provided by a clearing dealer as part of a clearing arrangement?

The following services are not provided by the clearing dealer under a clearing arrangement:

- trade and/or account financing;
- custody of client cash, security and investment product positions;

Trade/account financing

In the case of trade/account financing, this service is not provided by the clearing dealer given that in a DAP/RAP account:

- all trade purchase obligations must be fully paid for by the client on the settlement date of the trade; and
- all trade sales obligations must be met by the client by delivering the security or investment product position being sold to the clearing dealer on the settlement date of the trade.

There is therefore, no need for the clearing dealer to finance purchases or to borrow securities on the client's behalf to cover short sale obligations and no general need to finance client trades or client account balances.

Custodial services

Custodial services are not provided by the clearing dealer under a clearing arrangement, given that in a DAP/RAP account, the clearing dealer is never responsible for holding cash and/or security positions in custody for the other dealer or the other dealer's clients. To illustrate this point, consider the example of a purchase transaction that takes place in a DAP/RAP account. In this example the trade either:

- settles, and the purchased security is delivered out to the client's settlement agent custodian; or
- fails to settle, and the security becomes the legal property of the clearing dealer which it can hold or dispose of as it sees fit.

In both scenarios, there is no regulatory or contractual obligation for the clearing dealer to provide custodial services relating to the trade.

3. Is a clearing arrangement subject to the regulatory requirements set out in IIROC Dealer Member Rule 35 for introducing broker / carrying broker arrangements?

Included as part of IDA Member Regulation Notice MR-0096, *Introducing Broker / Carrying Broker Arrangements*, was a table setting out various functions/services that, if performed in combination by one dealer for another dealer, would constitute an introducing broker / carrying broker arrangement. This table and the discussion of the function/service



combinations that are considered to be an introducing broker / carrying broker arrangement has been updated to reflect changes in IROC rule numbering and is reproduced below:

“Certain *combinations* of functions provided by one firm to another constitute an Introducing Broker/Carrying Broker Arrangement, whereas other *combinations* of functions do not. The following are six main trading related functions that are performed:

Function #1	Function #2	Function #3	Function #4	Function #5	Function #6
Trade execution	Trade settlement	Custody of cash	Custody of securities	Book-keeping	Financing of customer positions

Functions or combinations of functions that **do not** constitute an Introducing Broker/Carrying Broker Arrangement include:

Functions #1 and #2 This combination of functions is a “jitney” or “omnibus” arrangement and is **not** subject to the requirements of the Introducing Broker/Carrying Broker Arrangement rules, as set out in Dealer Member Rule 35.

Functions #2, #3 and #4 This combination of functions is a custodial arrangement and is **not** subject to the requirements of the Introducing Broker/Carrying Broker Arrangement rules, as set out in Dealer Member Rule 35. Of course this arrangement is subject to other requirements set out in the IROC Dealer Member Rules relating to custody of customer cash and securities.

Functions #1, #2, and #5 This combination of functions is **not** subject to the requirements of Dealer Member Rule 35. The introducing broker/carrying broker requirements do not apply where cash and security custody is performed at a separate [entity] and assets are not commingled in any way with the service provider’s assets. This requires distinct segregation of securities by means of individual account FINS #s at the Canadian Depository for Securities Ltd. or other depository for securities of the service.

Function #5 The preparation of books and records is **not** subject to the requirements of Dealer Member Rule 35. This function is typically performed by a service bureau with the firm retaining the responsibility to comply the IROC Dealer Member Rule requirements for bookkeeping.

Combinations of functions that **do** constitute an Introducing Broker/Carrying Broker Arrangement include:

Functions #1 through #6 This combination of functions is subject to the introducing and carrying broker rules and is classified as



either a Type 1, 2 or 3 Arrangement pursuant to Dealer Member Rule 35.

Functions #1 through #5 This combination of functions is subject to the introducing and carrying broker rules where financing of customer positions is performed by the introducer and is classified as a Type 4 Arrangement pursuant to Dealer Member Rule 35.

Functions #2 through #6 This combination of functions is subject to the introducing and carrying broker rules where trade execution is performed by the introducer and is classified as either a Type 2 or 3 Arrangement pursuant to Dealer Member Rule 35.

Functions #2 through #5 This combination of functions is subject to the introducing and carrying broker rules where trade execution and financing of customer positions is performed by the introducer and is classified as a Type 4 Arrangement pursuant to Dealer Member Rule 35.”

A clearing arrangement is a combination of functions #1, #2 and #5 from the above table. As a result, a clearing arrangement is not considered to be an introducing broker / carrying broker arrangement and is not subject to the requirements set out in Dealer Member Rule 35. This is because clearing arrangement services do not obligate the clearing broker to provide custodial services for client cash, security and investment product positions.

5. What must be considered when entering into a clearing arrangement?

Given that a clearing arrangement is not considered to be an introducing broker / carrying broker arrangement, there are no specific IIROC Dealer Member Rules that apply to this business arrangement. There are however, relevant general rule requirements, practical considerations, outsourcing due diligence obligations and IIROC notification requirements that apply to clearing arrangements.

Relevant general rule requirements

As a clearing arrangement involves the execution, clearing and settlement of trades by the clearing broker on behalf of another dealer, the clearing broker will be exposed on a daily basis to the credit risk associated with each DAP/RAP account opened under the arrangement. As such, to the extent a trade settlement failure occurs and/or an unsecured debit balance exists in one or more accounts, the clearing broker would be required to provide for this credit risk in accordance with the account margining requirements set out in Dealer Member Form 1 and Dealer Member Rule 100.

Practical considerations

The following are practical issues to be addressed when a clearing arrangement is being considered:



- IIROC Form 1 categorizes dealers as being either “regulated entities” and “other brokers and dealers not qualifying as regulated entities” (both as defined in the General Notes and Definitions to Form 1). Clearing arrangements entered into involving dealers not qualifying as regulated entities introduce additional credit risk and regulatory margin requirements in the event there is a trade settlement default.
- To mitigate the credit risk assumed by a clearing broker pursuant to a clearing arrangement, clearing brokers should ensure that:
 - they have adequate credit risk management procedures in place to minimize the likelihood of credit risk-related losses; and
 - the clearing arrangements they enter into hold the introducing broker ultimately liable for any credit risk-related losses that arise.
- While IIROC rules do not prohibit “other non-individual clients”¹ and individual clients from opening DAP/RAP accounts, there are unique investor protection concerns, including for instance margin requirements and account trading restrictions resulting from overdue balances, that apply when the clearing arrangement involves such clients. Specifically, from an investor protection standpoint, IIROC’s margin requirements assume that “other non-individual clients” and individual clients that fail to meet their trade settlement obligations within a DAP/RAP account will be given more time after the trade settlement date to meet these obligations before a dealer will sell-out or buy-in the client’s security or investment product position. While there is no regulatory or contractual obligation for the clearing broker to provide custodial services in the case of an “other client” failed trade, street practice has been to provide such services

It is for these reasons that IIROC would expect that for any clearing arrangement involving an IIROC Dealer Member, either domestic, cross-border inbound or cross-border out-bound:

- For arrangements involving dealers other than dealers that qualify as a “regulated entity”, that stricter risk controls be put in place to mitigate any increased credit risk associated with such arrangements; and
- For any arrangement under which DAP/RAP accounts are opened for “other non-individual clients” and individual clients, that these clients would be provided with adequate information as to:
 - whether temporary custodial services will be provided by the clearing broker to the client in the event of a failed trade; and
 - if so, the length of time such services will be provided until the position is either sold out (in the case of a failed purchase) or bought in (in the case of a failed sale).

¹ For the purposes of this Guidance Note, “other non-individual client” means a non-individual client that does not qualify as an “acceptable institution”, “acceptable counterparty” or “regulated entity”, all of which are categories of non-individual clients defined within IIROC Dealer Member Form 1.



Outsourcing due diligence obligations

As a clearing arrangement is an outsourcing arrangement, Dealer Members are reminded of their due diligence obligations under National Instrument 31-103 and Companion Policy 31-103 CP, *Registration Requirements, Exemptions and Ongoing Registrant Obligations*, in respect of such arrangements. A separate Guidance Note, IIROC [Rules Notice #14-0012](#), setting out the key issues a Dealer Member should consider in meeting their due diligence obligations, is under development and has been recently published for public comment.

IIROC Notification requirements

IIROC Rules Notice 10-0060, *Reporting of Changes to Business Models*, requires Dealer Members to report to IIROC significant business model changes, including “changes to material operational processes which may impact trade execution, clearing, jitney, omnibus or settlement arrangements”. IIROC should therefore be informed of any material clearing arrangements that are being entered into by a Dealer Member.