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:
Legal and Compliance
Regulatory Accounting
Senior Management
Training

Contact:
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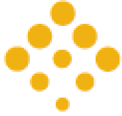
14-0257
November 6, 2014

Proposed amendments to Dealer Member Rule section 6.6 and corollary amendments to section 1.1 and subsection 16.2(iv) relating to the cross-guarantee requirement

Summary of the nature and purpose of the proposed rule amendments

On September 10, 2014, the Board of Directors ("Board") of the Investment Industry Regulatory Organization of Canada ("IIROC") approved the publication for comment of the proposed amendments to Dealer Member Rule section 6.6 and corollary amendments. Dealer Member Rule section 6.6 currently requires that Dealer Members that are at least 20% commonly-owned must guarantee each other's obligations to clients. This "cross-guarantee" requirement is designed to ensure that these Dealer Members, who participate in a common investor protection program offered by the Canadian Investor Protection Fund ("CIPF"), do not structure their operations and their legal relationships with each other in a way that compromises investor protection and/or shifts business risk from commonly-owned Dealer Members to CIPF.

The current rule requirement warrants revision to ensure that the rule focuses on those situations where the "fairness" of who pays for the insolvency of a commonly-owned Dealer Member is a concern - specifically, to focus on those situations where two or more Dealer Members, directly or indirectly, have the same controlling shareholder. To achieve this objective, IIROC staff are proposing to make amendments to Dealer Member Rule section 6.6. If approved and implemented,



these amendments would revise the minimum common ownership and board of directors membership percentages that trigger the cross-guarantee requirement from their current level of "at least 20%" to "greater than 50%". The benefits of these proposed higher percentages are that they:

- limit the requirement to enter into a cross-guarantee agreement to situations where it is clear that the same shareholder controls the decision making at both Dealer Members;
- reduce the constraint that exists within the current rules relating to Dealer Members raising capital from other Dealer Members, as the prospect of having to enter into a cross-guarantee agreement currently acts as a strong current disincentive to invest in other Dealer Members above the 19.9% level; and
- simplify the rule requirement, as it would allow use the same bright-line tests and percentage levels that are generally used under corporate law to determine which corporations are considered to be "affiliates".

Corollary amendments are also being proposed to:

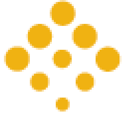
- Dealer Member Rule section 1.1 to clarify the application of the "Holding Company" definition; and
- Dealer Member Rule subsection 16.2(iv) to, consistent with the proposed amendments to Dealer Member Rule 6.6, narrow the scope of situations where a Dealer Member can file regulatory financial information with IIROC that is consolidated with the information of another commonly-owned Dealer Member, to those situations where the Dealer Members are more than 50% commonly owned.

Issues and specific proposed amendments

Relevant history

The cross-guarantee requirement was initially implemented in the early 1980s by the Investment Dealers Association (IDA) and the other Canadian stock exchange self-regulatory organizations (Canadian SROs) at a time when the issues of public ownership and diversification within the securities industry were being considered. At that time the following two IDA reports were issued:

- *Report of the Joint Industry Committee on Public Ownership in the Canadian Securities Industry* (a report issued in March 1981 referred to as the "Public Ownership Report"); and
- *IDA Report of the Joint Industry Committee on Diversification of Securities Firms and their Holdings Companies*(a report issued in May 1982 referred to as the "Diversification Report");



It was in the by-laws that were developed by the IDA and the other Canadian SROs, to implement the recommendations of these reports, that the notion of a mandatory cross-guarantee between Dealer Members and their related companies first appeared.

It is of interest to note that neither of these reports referred to above discussed or recommended the implementation of a cross-guarantee requirement. In fact, the reports discussed and focused their recommendations on a different issue, namely whether Dealer Members were exposed to the liabilities of:

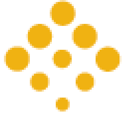
- securities firms that were not within the Canadian investment dealer SRO system; or
- businesses that were not related to the securities industry.

With that background, it is somewhat surprising that the draft IDA rules, developed to implement the recommendations of these two reports, imposed the positive obligation to provide a cross-guarantee between Dealer Members and other related Canadian registered dealers.

The specific reasons underlying the imposition of the cross-guarantee requirement are unclear. However, we do know that the Diversification Report indicated that “chartered accountants and others were considering the effect [of the recommendation to prohibit guarantees of other related entities] on the capital integrity of securities firms”. Further there was also a view at the time that without a cross-guarantee requirement an inequity could occur and there was potential for abuse if the owner of several securities firms permitted one of the firms to default on their obligations, while other commonly-owned firms continued operations. Without the cross-guarantee requirement, the rest of the industry would be held responsible for the obligations of the defaulting firm, by way of CIPF assessments, rather than the commonly owned firms. This result was viewed as being unfair and, further, could possibly encourage poor or reckless management. The "defaulters should pay first" view continues to reflect current industry thinking on this issue.

In light of this industry view, the cross-guarantee requirement was implemented, with three objectives:

- to encourage responsible behaviour by Dealer Members and reduce the risk of insolvency and/or loss of client property - this is primarily an investor protection objective.
- to ensure, in the event of a Dealer Member insolvency, that all dealers in the commonly-owned corporate group that includes the defaulting Dealer Member, pay first - this is primarily a fairness objective.



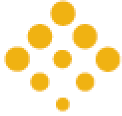
- to demonstrate the industry’s willingness to self-impose prudential rules in order to minimize the risk that the industry, as a whole, would have to bear the cost of client losses caused by risky or inappropriate behaviour by commonly-owned dealer groups - this is primarily an industry prudential objective.[1]

Original version and evolution of the cross-guarantee requirement

The original version of the cross-guarantee requirement appeared as part of IDA By-law section 5.18, which was implemented in 1981. The following table details the significant differences between the original provisions, as reflected in IDA By-law section 5.18, and the current IIROC Dealer Member Rule section 6.6:

	Original IDA By-law section 5.18	**Current IIROC Dealer Member Rule section 6.6** [black-lined to original IDA By-law section 5.18]
Scope of dealers subject to cross-guarantee requirement	Dealer Member and other Canadian registered dealer(s) with at least 10% common ownership	Dealer Member and other ~~Canadian registered dealer~~Dealer Member(s) with at least ~~10~~20% common ownership
Obligations guaranteed	All of the obligations of the other dealer	~~All of the~~The client obligations of the other dealer
Amount of the Dealer Member’s guarantee	100% of the Dealer Member’s regulatory capital	Where the Dealer Member is a Parent, 100% of the Dealer Member’s ~~regulatory~~ capital employed. Where the Dealer Member is related to the other Dealer Member because of a common ownership percentage held by another company, the amount of the Dealer Member’s capital employed that corresponds to the percentage ownership interest held by the other company in the other Dealer Member.
Amount of the other dealer’s	100% of the other Canadian	~~100%~~Where the other Dealer

[1] It should be noted that apart from the risk of industry financial loss, there was a paternalistic aspect to the rule in that it was intended to discourage moving risky business to one entity and leaving "safer" business in another entity. This practice of splitting risk and capital was and has been viewed as being inappropriate and not in the public interest. Moreover, if such practices resulted in losses, the defaulter's resources, and those of its related dealers (as defined), should all be exhausted before the credit ring of the rest of the industry through CIPF would have to respond.

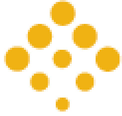


	Original IDA By-law section 5.18	**Current IIROC Dealer Member Rule section 6.6** [black-lined to original IDA By-law section 5.18]
guarantee	registered dealer's regulatory capital	Member is a Subsidiary, the amount of the other Canadian registered dealer's regulatoryDealer Member's capital employed that corresponds to the Dealer Member's percentage ownership interest in the other Dealer Member. Where the other Dealer Member is related to the Dealer Member because of a common ownership percentage held by another company, the amount of the other Dealer Member's capital employed that corresponds to the percentage ownership interest held by the other company in the Dealer Member.

Concerns with current cross-guarantee requirement

Dealer Members affected by the cross-guarantee requirement have, over the years, expressed concerns regarding the cross-guarantee requirement. Their concerns have focused on whether the rule is necessary, whether the rule fairly and effectively protects investors and the impact of the rule itself on Dealer Members. More specifically, the rule's detractors have argued that the current minimum common-ownership threshold, of at least 20%:

- Is unfair, as the percentage is too low:
    - to give the common owner the ability to control the decision-making at two or more Dealer Members; and
    - to justify requiring that the common owner to "pay first", in accordance with the "defaulters should pay first" philosophy
- Is ineffective at targeting only commonly-owned Dealer Members with the potential for significant investor protection risk. They argue that certain minority interest, common-ownership situations (i.e. situations where the common ownership is between 20% and 50%) are inappropriately treated in the same manner as majority common-ownership situations, where common control is undeniable; and
- Creates an unintended disincentive for Dealer Members to acquire more than 19.9%



common ownership in other Dealer Members (either directly or indirectly), which stifles inter-dealer investments that could have a positive impact on the overall financial stability of the industry.

Alternatives

To respond to the concerns expressed, we could eliminate the current rule requirement, amend the current rule requirement to address the fairness, investor protection effectiveness and rule impact concerns, or develop specific criteria to assist the Board in considering future requests for exemptive relief from the current rule requirement.

Alternative #1: Elimination of the current rule requirement

Eliminating the current rule requirement would be the preferred alternative if it was determined that there were no longer any benefits to retaining the rule. Since one of the primary objectives of establishing the rule was ensuring fairness by requiring defaulters to pay first, eliminating the rule might be justified if there was no longer an industry view that commonly-owned Dealer Members should pay first in the event of a Dealer Member insolvency and no other benefits to retaining the rule are identified.

Alternative #2: Amendment of the current rule requirement

Amending the current rule requirement would be the preferred option if it is believed that the current rule continues to be beneficial in certain cases within the current rule's scope and requires revision to limit the application of the rule requirement to those cases.

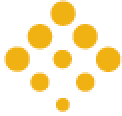
Alternative #3: Development of specific exemption criteria

Developing specific exemption criteria would be the preferred alternative if it could be demonstrated that while the current rule continues to provide benefits, exemption criteria need to be developed to ensure that exemption requests are dealt with fairly and consistently and do not undermine the regulatory purpose of the rule.

Assessment of alternatives

In assessing these alternatives, IIROC staff revisited the primary objective of the cross-guarantee rule and reviewed the requests for exemptive relief from the cross-guarantee requirement that IIROC (and its predecessor, the IDA) has received since the rule was adopted.

In revisiting the primary objective for adopting the cross-guarantee rule, we believe that there continues to be an industry view that fairness requires commonly-owned Dealer Members to pay



first when a Dealer Member insolvency occurs. We'd be interested in receiving the views of Dealer Members and other stakeholders on this issue as part of the public comment process.

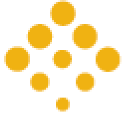
As a result of reviewing previous requests for exemptive relief from the cross-guarantee requirement, we'd identified three scenarios where we believe no regulatory benefit would result from continuing to require the execution of a cross-guarantee agreement:

1. Where the common ownership percentage is less than or equal to 50%;
2. Where at least one of the commonly owned Dealer Members operates as an "alternative trading system", as defined in National Instrument 21-101; and
3. Where none of the Dealer Members have clients with accounts that are eligible for CIPF protection.

Regarding the first scenario, there is little regulatory benefit derived from executing a cross-guarantee agreement where the common ownership of two or more Dealer Members is less than or equal to 50% as there is no clear evidence that the firms are under the control of a common owner.

Regarding the second scenario, there is no regulatory benefit derived from executing a cross-guarantee agreement where one of the commonly-owned Dealer Members operates as an "alternative trading system", as defined in National Instrument 21-101. An alternative trading system operates as a marketplace, even though it must be registered as an investment dealer and must be a Dealer Member of IIROC. There are important market integrity reasons why a marketplace should be operated through a separate legal entity from that of a commonly-owned investment dealer that is facilitating investment product transactions for its clients and/or engaging in proprietary trading in investment products. Without such separation, the financial viability of the marketplace could be at risk where the dealer operations of the entity incur significant losses, and this could in turn negatively affect many more market participants (and their clients) should the losses result in the shutting down of the marketplace and/or the cancelling of trades executed on that marketplace. We therefore believe that we would introduce the possibility of regulatory harm, if we required a marketplace to guarantee the client obligations of other commonly-owned Dealer Members.

Regarding the third scenario, there would be no regulatory benefit derived from executing a cross-guarantee agreement amongst commonly-controlled Dealer Members if none of the Dealer Members have clients that are eligible for CIPF coverage. In the absence of the CIPF coverage, no unrelated Dealer Members would have to bear the cost of making clients whole, eliminating the "defaulters should pay first" logic that underpins the cross guarantee requirement.



Proposed cross-guarantee rule amendments

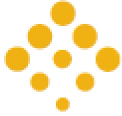
IIROC staff believe that fairness requires that "defaulters should pay first". As such, it is important that the IIROC Dealer Member Rules continue to require that two or more Dealer Members execute a cross-guarantee agreement, in situations where the Dealer Members are commonly controlled by the same shareholder. Without this safeguard in place:

- an affiliated Dealer Member, where there is greater than 50% common ownership, will be no more liable for the insolvency of its affiliated Dealer Member than an unaffiliated Dealer Member would be; and
- our rules will no longer discourage the practice of “risk splitting” (whereby the business activities of one Dealer Member are conducted through two Dealer Members, with one entity conducting the riskier business activities and the other entity conducting the less risky business activities).

We also believe there are three scenarios (as discussed above) in which there is no regulatory benefit to requiring the execution of cross-guarantee agreements.

We are therefore recommending that the current rule requirement be retained, but amended in order to ensure that the rule only applies to situations in which the common ownership of multiple Dealer Members poses a material investor protection risk. To achieve this objective, the proposed amendments to Dealer Member Rule section 6.6 would specifically exclude the following situations from the cross-guarantee requirement:

- where the common ownership and common board of directors membership percentage of two or more Dealer Members is 50% or less (the current exclusion is a common ownership percentage of less than 20%);
- where one or more of the commonly owned Dealer Members operates as an “alternative trading system” (“ATS”) as defined in National Instrument 21-101, only the non-ATS Dealer Members within the common ownership group would be subject to the cross-guarantee requirement; and
- where none of the commonly-owned Dealer Members have clients with accounts that are eligible for CIPF protection.



Corollary amendments to IIROC Dealer Member Rule section 1.1 and subsection 16.2(iv)

The current definition of "Holding Company" set out in Dealer Member Rule section 1.1 gives the applicable District Council the authority to deem an entity to be included in or excluded from "Holding Company" definition. Because IIROC staff would never ask that a District Council to deem an entity that is not otherwise captured under the definition to be included in the definition, the wording has been revised to narrow the District Council's role to considering exclusions from the definition.

Current IIROC Dealer Member Rule subsection 16.2(iv) gives commonly-owned Dealer Members the option of filing regulatory financial information with IIROC that is consolidated with the information of another commonly-owned Dealer Member, provided the other Dealer Member is a related company (i.e., at least 20% common ownership). The reason for this stipulation in the current rule requirement is that all Dealer Members that are related companies with each other must cross-guarantee each other's client obligations under the current cross-guarantee rule and can therefore be considered to be one entity, for regulatory financial solvency purposes.

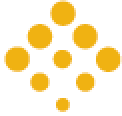
As we are now proposing to limit the cross-guarantee requirement to situations where the Dealer Members are more than 50% commonly owned (i.e., affiliated company situations) we're also proposing to limit the ability to file consolidated reports to situations where the commonly owned Dealer Members are "affiliated companies".

Clean and black-line copies of the proposed amendments to Dealer Member Rule section 6.6, section 1.1 and subsection 16.2(iv) are included as Attachments A and B.

Comparison with similar provisions

We have reviewed the requirements applicable to securities firms in Australia, the United Kingdom and the United States and we have not identified any rule or requirement that corresponds to Dealer Member Rule section 6.6. There are, however, two similar regulatory requirements that have been identified, the details of which are as follows:

- In Australia, the national securities regulator, the Australian Securities and Investments Commission (ASIC), requires cross-guarantees of firms that are part of the same corporate group if they wish to consolidate financial reporting. ASIC Class Order [CO 98/1418] provides relief to certain companies that are part of a corporate group. These companies are relieved of the obligation to file separate financial reports, director's reports and auditor's reports. This is similar to IIROC Dealer Member Rule 16.2(iv). Relief is only available to



wholly-owned subsidiaries under certain conditions, one of which is that the group of companies execute a deed of cross-guarantee in which each company guarantees payment in full to each creditor of any debt, in accordance with the deed. The ASIC provides a pro-forma deed of cross-guarantee to be used by those applying for relief.

- In the United States, the Federal Deposit Insurance Corporation (FDIC) has statutory powers that are similar, in effect, to those of cross-guarantees. Section 206(a)(7) of the *Financial Institutions Reform, Recovery and Enforcement Act of 1989* amended the *Federal Deposit Insurance Act* to give the FDIC the power to hold any insured depository institution liable for any loss incurred by the FDIC in connection with the default of, or any assistance provided to, another commonly controlled insured depository institution. Effectively, this is a cross-guarantee requirement imposed by statute. Although similar in effect to the IIROC Rule, the FDIC's "cross-guarantee authority" gives FDIC the power to impose liability *ex post facto.* This reduces the predictability of its use. It should also be noted that some commentators have cited examples of this statutory power causing the failure of viable banks. In one example, the FDIC assessed the Maine National Bank (MNB) the amount the FDIC estimated it would incur in resolving the failure of the Bank of New England, a sister bank. As soon as the assessment was entered as a valid debt, MNB was declared insolvent. MNB was an otherwise healthy bank.

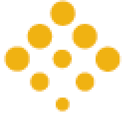
Effects of proposed amendments on market structure, Dealer Members, non-members, competition and costs of compliance

While the adoption of the amendments will result in fewer Dealer Members being required to enter into a cross-guarantee agreement, it is not anticipated that this reduction in the number of agreements that are executed will significantly affect the default risk borne by CIPF and the rest of the investment dealer community through their participation in CIPF. Adoption of the proposed amendments will have no impacts on market structure, non-members, competition and costs of compliance.

Classification of proposed rule amendments

Statements have been made elsewhere as to the nature and effects of the proposed rule amendments, as well as analysis. The purposes of the proposed rule amendments are to:

- *establish and maintain rules that are necessary or appropriate to govern and regulate all aspects of IIROC's functions and responsibilities as a self-regulatory entity,*



- *foster fair, equitable and ethical business standards and practices, and*
- *promote the protection of investors.*

The Board therefore has determined that the proposed amendments are not contrary to the public interest.

IIROC has determined that the proposed amendments are Public Comment Rules and they will therefore be published for comment.

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 by February 4, 2015 (90 days from the publication date of this notice). One copy should be addressed to the attention of:

Mindy Kwok
Information Analyst, Member Regulation Policy
Investment Industry Regulatory Organization of Canada
Suite 2000, 121 King Street West
Toronto, ON M5H 3T9

The second copy should be addressed to the attention of:

Manager of Market Regulation
Ontario Securities Commission
19th Floor, Box 55
20 Queen Street West
Toronto, ON 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 – Proposed Policy").

Questions may be referred to:

Mindy Kwok
Information Analyst, Member Regulation Policy
Investment Industry Regulatory Organization of Canada
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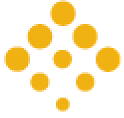

Attachments

Attachment A - Text of proposed amendments; and

Attachment B - Black-line text of proposed amendments.