

IIROC NOTICE

Rules Notice Request for Comments

Dealer Member Rules

Comments Due By: May 25, 2016

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Legal and Compliance
Operations
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Contact:

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16-0038
February 25, 2016

Proposed amendments to Dealer Member Rule 300.2(a)(vii) regarding the audit requirement to send second positive confirmation requests

Executive Summary

On January 27, 2016, the Board of Directors (the “Board”) of the Investment Industry Regulatory Organization of Canada (“IIROC”) approved the publication for comment of proposed amendments to Dealer Member Rule 300.2(a)(vii) regarding the audit requirement to send second positive confirmation requests (the “Proposed Amendments”).

The primary purpose of the Proposed Amendments is to provide independent auditors with a practical solution to address their concern that the current IIROC audit requirement to send second positive confirmation requests to all of a Dealer Member’s clients, who did not reply to the initial positive confirmation request, is onerous and redundant given:



- (1) the relatively short timeframe to complete a Form 1 audit in order to meet IIROC's audited Form 1 filing deadline;
- (2) second requests for confirmations are routinely sent to parties by auditors within a few days of the sending the first confirmation requests;
- (3) appropriate alternative verification procedures are already well underway and performed for these Dealer Member's client accounts in order to meet this short timeframe; and
- (4) the audit, including the use of appropriate alternative verification procedures, is performed in accordance with the Canadian Auditing Standards ("CAS").

The Proposed Amendments would give an independent auditor the option (rather than it being a requirement) to send second positive confirmation requests to the Dealer Member's clients, who did not reply to the initial positive confirmation request, and would require the independent auditor use appropriate alternative verification procedures to obtain relevant and reliable audit evidence where second positive confirmation requests are not sent.

How to Submit Comments

Comments are sought on the Proposed Amendments. Comments should be made in writing. A copy of each comment letter should be delivered by May 25, 2016 (90 days from the publication date of this notice) to:

Anwerd Ramcharan
Manager, Financial Information, Member Regulation Policy
Investment Industry Regulatory Organization of Canada
Suite 2000, 121 King Street West
Toronto, Ontario, M5H 3T9
aramcharan@iiloc.ca

A copy should also be provided to the Recognizing Regulators by forwarding a copy to:

Manager of Market Regulation
Ontario Securities Commission
19th Floor, Box 55
20 Queen Street West
Toronto, Ontario, M5H 3S8
marketregulation@osc.gov.on.ca

Commentators should be aware that a copy of their comment letter will be made publicly available on the IIROC website at www.iiloc.ca.



Questions may be referred to:

Answerd Ramcharan
Manager, Financial Information, Member Regulation Policy
Investment Industry Regulatory Organization of Canada
(416) 943-5850
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Discussion of Proposed Amendments

Relevant background

In 2009, Canada adopted new CAS for the audits of financial statements and other historical financial information, for periods ending on or after December 14, 2010. The CAS are now effective in Canada and are a part of Canadian generally accepted auditing standards. In 2011, IIROC adopted the new Canadian generally accepted accounting standards (except for prescribed departures), International Financial Reporting Standards (IFRS), for IIROC Form 1.

Independent auditors of Dealer Members are required to conduct their audits in accordance with Canadian generally accepted auditing standards and the requirements in IIROC Dealer Member Rule 300 “Audit Requirements”. Under Dealer Member Rule 300.2(a)(vii), independent auditors are required to obtain written confirmation for certain balances, positions, accounts, guarantees and statements as detailed in (vii)(1)-(9) of this rule, and IIROC deems compliance with these confirmation requirements where the independent auditor:

- (1) mails a positive request for confirmation in an envelope bearing the independent auditor’s return address;
- (2) similarly mails a second positive request for confirmation to those not replying to the initial request; and
- (3) uses appropriate alternative verification procedures where replies to second positive requests for confirmation have not been received.

The broker-dealer panel auditor committee, which is a committee, comprised of senior audit partner representatives from each national firm in Canada, that serves to provide timely and valuable input and feedback to IIROC on audit and accounting standards and regulatory requirements applicable to Dealer Members (the “Panel Auditor Committee”), has assessed whether the requirement to send second positive confirmation requests provides significant additional audit value, given that (1) there are other areas where the independent auditor’s work provides sufficient audit evidence to mitigate the audit risk over those items in (vii)(1)-(9)



of the above rule, and (2) IIROC's short deadline for the filing of a Dealer Member's audited Form 1, which is 49 days after a Dealer Member's fiscal year-end.

These other areas, where the independent auditor's work provides sufficient audit evidence to mitigate the audit risk over those items in (vii)(1)-(9) of the above rule, include CAS 330, 500 and 505.

Canadian Auditing Standards

As part of the requirements for auditors to perform their audit in accordance with generally accepted auditing standards, auditors are required to comply with CAS. CAS 330 "the auditor's responses to assessed risks", 500 "audit evidence", and 505 "external confirmations" provide specific guidance to auditors in connection with external confirmations, including:

- the identification of situations where external confirmations provide relevant audit evidence,
- the factors to consider if external confirmations provide less relevant audit evidence, and
- the knowledge, objectivity and willingness of the confirming party to respond to these confirmations.

CAS 330 "the auditor's responses to assessed risks"

- This deals with the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with CAS 315 "identifying and assessing the risks of material misstatement through understanding the entity and its environment" in an audit of financial statements. It requires that the auditor obtain more persuasive audit evidence the higher the auditor's assessment of risk.

CAS 500 "audit evidence"

- This explains what constitutes audit evidence in an audit of financial statements, and deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion. In addition, it is applicable to all the audit evidence obtained during the course of the audit.

CAS 505 "external confirmations"

- This deals with the auditor's use of external confirmation procedures to obtain audit evidence in accordance with the requirements of CAS 330 and CAS 500. It does not



address inquiries regarding litigation and claims, which are dealt within CAS 501 “audit evidence - specific considerations for selected items”.

CAS 505 paragraph 12 “non-responses”

- Requires auditors to perform alternative audit procedures to obtain relevant and reliable audit evidence when confirmations are not received.
- Typically for Dealer Member clients, this includes verification procedures for non-responding positive accounts by inspecting transaction activity in their accounts, examination of subsequent client statements, other procedures to verify the accuracy of client activity and/or other alternative procedures. It is acknowledged that one of these alternative procedures is to send follow on confirmations in accordance with CAS 505 - Application and Other Explanatory Material Section A7, which identifies that an auditor may send an additional confirmation request when a reply has not been received within a reasonable time.
- For audits of IIROC Dealer Members, the assessment of receipt within a reasonable time becomes difficult due to the short-time frame required to complete the audit of the Form 1 (required completion within 49 days of fiscal year-end). With this tight deadline, in practice second requests for confirmations are routinely sent out to parties by auditors within a few days of the sending out the first confirmations in order to “fulfill” the audit requirement, but practically providing no value to the audit. As those parties who intend to respond to the confirmation request will have already done so on the first request, or are in the process of doing so when they receive the second request. Alternatively, counterparties may not comply with either request.
- A summary comparison of current IIROC audit confirmation and filing deadline requirements to other regulated financial institutions is provided in Attachment E.
- As noted above, CAS 505 does provide guidance for auditors who do not receive responses on confirmation requests. For example, the auditor may, having re-verified the accuracy of the original address, send an additional or follow-up request. However, this follow on request procedure is not required under the CAS 505 guidance and furthermore, in normal practice, auditors typically do not send follow-up requests over the course of “traditional” audits (i.e. when conducting a financial statement audit of an entity that is not regulated by IIROC).

CAS 505 paragraph 14 “exceptions”

- Requires auditors to investigate exceptions to determine whether or not they are indicative of misstatement. Upon receipt of a discrepancy from a confirmation either



confirmed positively or negatively, auditors investigate the matter with management of the Dealer Member until the matter is adequately addressed.

CAS 505 - Application and Other Explanatory Material Section A11 -14 (Reliability of Responses to Confirmation Requests)

- Provides guidance where evidence is obtained from external sources, but circumstances may exist that affect its reliability. These sections provide guidance of the procedures auditors should consider to assess the reliability, proof of origin and authority of the respondent.

CAS 505 paragraph 15 “negative confirmations”

- Under IIROC Dealer Member Rule 300.2(a)(vii), auditors of Dealer Members negatively confirm all client accounts at year-end, which provides some level of substantive evidence over the most voluminous area of the confirmation process. This is consistent with the CAS 505 paragraph 15 guidance where there is a low risk of material misstatement and a low exception rate is expected.
- This assessment of low risk is typically determined based on other procedures performed by the auditor, including the assessment that the majority of Dealer Members who maintain client accounts on their books use an external service provider to record client transactions. In these instances, auditors typically examine the CSAE3416 service organization report or in rare circumstances, where a CSAE3416 service organization report is not issued, perform test of controls at the service organization in order to rely on the underlying reports of the service organization.

CAS 505 paragraph 7 “external confirmation procedures” and A6 “designing confirmation requests”

- Depending on the risks and complexity of the Dealer Member, auditors may test controls over the return mail process (client statements returned due to incorrect name or address). This procedure performed in accordance with CAS 505 paragraph 7 and A6 and is to ensure confirmations are sent to the appropriate client address and is confirmed by examining the process and controls in place by the Dealer Member’s management over client mail that is returned to the Dealer Member and the subsequent follow-up action that is taken place by the Dealer Member’s management.
- Auditors will also inspect returned client statements, notify management and examine the follow-up action taken, and substantiate subsequent activity in these accounts.



Current rule

As previously discussed, independent auditors of Dealer Members are required to conduct their audits in accordance with Canadian generally accepted auditing standards and the requirements in IIROC Dealer Member Rule 300 “Audit Requirements”. Under Dealer Member Rule 300.2(a)(vii), independent auditors are required to obtain written confirmation for certain balances, positions, accounts, guarantees and statements as detailed in (vii)(1)-(9) of this rule, and IIROC deems compliance with these confirmation requirements where the independent auditor:

- (1) mails a positive request for confirmation in an envelope bearing the independent auditor’s return address;
- (2) similarly mails a second positive request for confirmation to those not replying to the initial request; and
- (3) uses appropriate alternative verification procedures where replies to second positive requests for confirmation have not been received.

Proposed rule

The Proposed Amendments would give an independent auditor the option to send second positive confirmation requests to the Dealer Member’s clients, who did not reply to the initial positive confirmation request, rather than it being a requirement, and would require that the independent auditor use appropriate alternative verification procedures to obtain relevant and reliable audit evidence where second positive confirmation requests are not sent. In addition, Dealer Member Rule 300.2(a)(vii) would continue to require that the independent auditor use appropriate alternative verification procedures to obtain relevant and reliable audit evidence where replies to second positive confirmation requests have not been received.

Issues and alternatives considered

Two alternatives were considered, namely: (1) to continue to require the independent auditor to mail a second positive request for confirmation to those not replying to the initial request; and (2) to make it an option for the independent auditor to send second positive request for confirmation to those not replying to the initial request, and require that the independent auditor use appropriate alternative verification procedures to obtain relevant and reliable audit evidence where second positive confirmation requests are not sent.

IIROC staff selected the second alternative, because we agree that the requirement to always send second positive request for confirmation to those not replying to the initial request does



not provide significant additional audit evidence for those items in Dealer Member Rule 300.2(a)(vii)(1)-(9) given:

- (1) the relatively short timeframe to complete a Form 1 audit in order to meet IIROC's audited Form 1 filing deadline;
- (2) second requests for confirmations are routinely sent to parties by auditors within a few days of the sending the first confirmation requests;
- (3) appropriate alternative verification procedures are already well underway and performed for these Dealer Member's client accounts in order to meet this short timeframe; and
- (4) the audit, including the use of appropriate alternative verification procedures, is performed in accordance with CAS.

Comparison with similar provisions

U.S. Securities and Exchange Act Rule 17a-5 requires that the Financial Industry Regulatory Authority ("FINRA") member firms (also referred to as "broker-dealers") file an annual audited report not more than 60 calendar days after the date selected for their fiscal year end.¹ Additionally, all FINRA members who are members of the Securities Investor Protection Corporation ("SIPC") and who are required to file Annual Reports pursuant to SEC Rule 17a-5(d)(1), 17 C.F.R. § 240.17a-5(d)(1), must also file a copy of their Annual Reports with SIPC. Similarly, an IIROC Dealer Member's audited Form 1 must be filed with IIROC and the Canadian Investor Protection Fund ("CIPF"), but within 49 calendar days after the Dealer Member's fiscal year-end.

In the U.S., the Public Company Accounting Oversight Board ("PCAOB") oversees the audits of broker-dealers, including compliance reports filed pursuant to federal securities laws, to promote investor protection. PCAOB AS 2310², "The Confirmation Process", provides guidance about the confirmation process in audits performed in accordance with U.S. generally accepted auditing standards. Under AS 2310 section 16, "Designing the Confirmation Request", the auditor should tailor the confirmation requests to the specific audit objectives and consider factors that are likely to affect the reliability of the confirmations. These factors include the form of the confirmation request (positive or negative), prior experience on the audit or similar engagements, the nature of the information being confirmed, and the intended respondent (party).

¹ <http://www.finra.org/industry/annual-audit>

² <http://pcaobus.org/Standards/Auditing/Pages/AS2310.aspx>



Under AS 2310 section 30, “Performing Confirmation Procedures”, for positive confirmation requests the auditor should generally follow up with a second and sometimes third request to those parties from whom replies have not been received. Although this guidance recommends additional positive confirmation requests for the audit of US broker-dealers, it is not practical for the audit of IIROC Dealer Members given the shorter timeframe in which a Dealer Member’s Form 1 must be audited and filed with IIROC and CIPF. In addition, this PCAOB guidance is subject to the judgment of the audit team and the auditor is not mandated to send second positive confirmation requests. The auditors would always consider the option to send second requests along with other audit methods to obtain the confirmation (e.g. e-mail, verbal discussion, etc.) or perform alternative procedures to obtain sufficient audit evidence.

Under AS 2310 sections 31 and 32, “Alternative Procedures”, when the auditor has not received replies to positive confirmation requests, he or she should apply alternative procedures to the nonresponses to obtain the evidence necessary to reduce audit risk to an acceptably low level. In addition, the nature of alternative procedures should vary according to the account and assertion in question.

Impacts

The Proposed Amendments do not impose any burden or constraint on competition or innovation that is not necessary or appropriate in furtherance of IIROC’s regulatory objectives. They do not impose costs or restrictions on the activities of market participants (including Dealer Members and non-Dealer Members) that are disproportionate to the goals of the regulatory objectives sought to be realized.

The Proposed Amendments will have no material impact on Dealer Members’ systems.

Implementation

It is intended that the Proposed Amendments will be implemented shortly after approval is received from IIROC’s recognizing regulators.

Regulatory Development Process

Regulatory purpose

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



- foster cooperation and coordination with entities engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in, securities, and
- promote the protection of investors.

Regulatory process

The Board therefore has determined that the Proposed Amendments are not contrary to the public interest.

The Financial Administrators Section (FAS), FAS Capital Formula Subcommittee and FAS Executive Committee, which are policy advisory committees of IIROC, were consulted and supported the Proposed Amendments.

Due to the extent and substantive nature of the Proposed Amendments, they have been classified as Public Comment Rule proposals.

Attachments

Attachment A - Text of the proposed amendments to Dealer Member Rule 300.2(a)(vii)

Attachment B - Clean copy of the proposed amendments to Dealer Member Rule 300.2(a)(vii)

Attachment C - Black-line copy of the proposed amendments to Dealer Member Rule 300.2(a)(vii)

Attachment D - Black-line copy of proposed plain language version of Dealer Member Rule 300.2(a)(vii)

Attachment E - Summary comparison of current IIROC audit confirmation and filing deadline requirements to other regulated financial institutions

INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA
PROPOSED AMENDMENTS TO DEALER MEMBER RULE 300.2(A)(VII) REGARDING THE AUDIT
REQUIREMENT TO SEND SECOND POSITIVE CONFIRMATION REQUESTS

TEXT OF PROPOSED AMENDMENTS

1. Dealer Member Rule 300.2(a)(vii) is as amended by:
 - (a) deleting the word “and” immediately after the words “Auditor’s return address”;
 - (b) adding the words “. The Dealer Member’s Auditor has the option to send out” immediately after “Auditor’s return address”;
 - (c) deleting the word “are” immediately before the words “similarly mailed to”;
 - (d) deleting the word “where” immediately after the words “procedures must be used”;
and
 - (e) adding the words “to obtain relevant and reliable audit evidence where second requests are not sent out or” immediately before the words “replies to second requests”.

INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA
PROPOSED AMENDMENTS TO DEALER MEMBER RULE 300.2(A)(VII) REGARDING THE AUDIT
REQUIREMENT TO SEND SECOND POSITIVE CONFIRMATION REQUESTS

CLEAN COPY OF PROPOSED AMENDMENTS

1. A clean copy of the proposed amendments to Dealer Member Rule 300.2(a)(vii) is as follows:

“The Dealer Member's Auditor shall:

- (a) As of the audit date:

-
-
-

- (vii) Obtain written confirmation with respect to the following:

-
-
-

Compliance with the confirmation requirements shall be deemed to have been made if positive requests for confirmation have been mailed by the Dealer Member's Auditor in an envelope bearing the Auditor's return address. The Dealer Member's Auditor has the option to send out second requests similarly mailed to those not replying to the initial request. Appropriate alternative verification procedures must be used to obtain relevant and reliable audit evidence where second requests are not sent out or replies to second requests have not been received. For accounts mentioned in (4), (6) and (7) above, the Dealer Member's Auditor shall (i) select specific accounts for positive confirmation based on (a) their size (all accounts with equity exceeding a certain monetary amount, with such amount being related to the level of materiality) and (b) other characteristics such as accounts in dispute, accounts that are significantly undermargined, nominee accounts, and accounts that would require significant margin during the year or as at year-end without the existence of an effective guarantee, and (ii) select a representative sample from all other accounts of sufficient extent to provide reasonable assurance that a material error, if it exists, will be detected. For accounts in (4), (6) and (7)

Attachment B

above that are not confirmed positively, the Dealer Member's Auditor shall mail statements with a request that any differences be reported directly to the auditor. Clients' accounts without any balance whatsoever and those closed since the last audit date shall also be confirmed on a test basis using either positive or negative confirmation procedures, the extent to be governed by the adequacy of the system of internal control;”

INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA
PROPOSED AMENDMENTS TO DEALER MEMBER RULE 300.2(A)(VII) REGARDING THE AUDIT
REQUIREMENT TO SEND SECOND POSITIVE CONFIRMATION REQUESTS

BLACK-LINE OF PROPOSED AMENDMENTS

1. A black-line copy of the proposed amendments to Dealer Member Rule 300.2(a)(vii) is as follows:

“The Dealer Member's Auditor shall:

- (a) As of the audit date:

- .
- .
- .

- (vii) Obtain written confirmation with respect to the following:

- .
- .
- .

Compliance with the confirmation requirements shall be deemed to have been made if positive requests for confirmation have been mailed by the Dealer Member's Auditor in an envelope bearing the Auditor's return address ~~and~~ The Dealer Member's Auditor has the option to send out second requests ~~are~~ similarly mailed to those not replying to the initial request. Appropriate alternative verification procedures must be used ~~where~~ to obtain relevant and reliable audit evidence where second requests are not sent out or replies to second requests have not been received. For accounts mentioned in (4), (6) and (7) above, the Dealer Member's Auditor shall (i) select specific accounts for positive confirmation based on (a) their size (all accounts with equity exceeding a certain monetary amount, with such amount being related to the level of materiality) and (b) other characteristics such as accounts in dispute, accounts that are significantly undermargined, nominee accounts, and accounts that would require significant margin during the year or as at year-end without the existence of an effective guarantee, and (ii) select a representative sample from all other accounts of sufficient extent to provide reasonable assurance that a material error, if it exists, will be detected. For accounts in (4), (6) and (7) above that are not confirmed positively, the Dealer

Attachment C

Member's Auditor shall mail statements with a request that any differences be reported directly to the auditor. Clients' accounts without any balance whatsoever and those closed since the last audit date shall also be confirmed on a test basis using either positive or negative confirmation procedures, the extent to be governed by the adequacy of the system of internal control;”

INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA

**PROPOSED AMENDMENTS TO DEALER MEMBER RULE 300.2(A)(VII) REGARDING THE AUDIT
REQUIREMENT TO SEND SECOND POSITIVE CONFIRMATION REQUESTS**

BLACK-LINE OF PROPOSED PLAIN LANGUAGE VERSION OF DEALER MEMBER RULE 300.2(A)(VII)

1. A black-line of copy of the proposed Plain Language Rule subsection 4183(1) is as follows:

“4183. Selection of accounts for positive confirmation

- (1) For accounts in subsection 4182(2), the *Dealer Member's auditor* must send out the positive confirmation requests in an envelope bearing the *auditor's* return address.
 - (i) The *Dealer Member's auditor* ~~must~~has the option to send out second requests to those not replying to the initial request.
 - (ii) The Dealer Member's auditor must perform appropriate alternative verification procedures,~~where~~used to obtain relevant and reliable audit evidence, where second requests are not sent out or replies to second requests have not been received.”

Summary comparison of current IIROC audit confirmation and filing deadline requirements to other regulated financial institutions.

Type of Company	Applicable Reporting Framework Required for External Confirmations	Section of applicable reporting framework applied for external confirmations	Does the applicable reporting framework require the entity to send mandatory second requests?	Can alternate procedures be taken instead of second requests?	Deadline for reporting results after year end
Investment Dealer	IIROC Rules	IIROC Rule 300.2(a)(vii)	Yes	No ⁶	49 days
Mutual Fund Dealer	Mutual Fund Dealer Association of Canada (MFDA) Rules	Mutual Fund Dealer Association of Canada Rule 3.6.2 (b) –Audit Procedures	Yes	No ⁷	90 days ⁸
Trust Company	OSFI and Canadian Auditing Standards (CAS)	CAS 505-External Confirmations	No	Yes	90 days ⁹
Financial Institution	OSFI and Canadian Auditing Standards (CAS)	CAS 505-External Confirmations	No	Yes	90 days ⁷
Insurance	OSFI (FSCO or equivalent) and Canadian Auditing Standards (CAS)	CAS 505-External Confirmations	No	Yes	90 days ⁷

⁶ Per IIROC Rule 300.2(a)(vii), appropriate alternative verification procedures must be used where replies to second requests have not been received.

⁷ Per Mutual Fund Dealer Association of Canada Rules, 3.6.2(b)-Audit Procedures, appropriate alternative verification procedures must be used where replies to second requests have not been received.

⁸ Per section 3.5.1 (b)-Filing Requirements of the Mutual Fund Association of Canada Rules, statements must be filed within 90 days of year end.

⁹ Assumed filing deadline for a public company, which would be more onerous than a private company based on the Ontario Securities Act, Regulations and Rules, Part 5, Ongoing Requirements, section 4.2 Filing Deadline for Annual Financial Statements.