

IIROC NOTICE

Rules Notice Request for Comments Dealer Member Rules

Comments Due By: December 19, 2016

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Guidance on Order Execution Only Services and Activities

Executive Summary

IIROC is publishing for comment proposed guidance (**Guidance**) regarding order execution only (**OEO**) services offered by Dealer Members pursuant to the IIROC Dealer Member Rules (**Appendix A**). The Guidance outlines our expectations and requirements applicable to all Dealer Members engaged in OEO activities (**OEO firms**).

Once implemented, the Guidance will replace [Member Regulation Notice MR-098 – What Constitutes a “Recommendation”? Is a Suitability Determination Required Under Regulation 1300.1](#), dated September 6, 2001 (**Recommendation Notice**).

The original OEO business model, developed in the early 2000s, was relatively straightforward. Generally, OEO firms offered clients trade execution services only with little to no ancillary tools or services (collectively, **tools**) and the products offered were primarily limited to listed securities. Current IIROC rules and guidance relating to the OEO business were developed at the same time and were reflective of the original OEO business model.

Since then, the OEO business model has evolved significantly with OEO firms now offering a wide variety of products, tools and account types. Further, broader changes have occurred in the investment industry which have impacted the OEO business model.



To explore these issues further, we engaged in extensive consultation with industry participants and associations, investor advocates and other domestic and international regulators. We also engaged an independent research firm to survey OEO clients to ascertain their views regarding some of the tools OEO firms make available to them.

In light of the evolving OEO business model, we are publishing Guidance to provide IIROC's views on the scope of products, tools and account types that we consider to be consistent with the OEO regulatory framework.

How to Submit Comments

Comments are requested on all aspects of the Guidance (including any matter which it does not specifically address). As discussed in Part 6 of this Notice, we are also seeking comments on the potential of IIROC granting (standardized) exemptive relief which would allow OEO firms to make available certain limited model portfolios to clients. Comments should be in writing and delivered by **December 19, 2016** to:

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



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1. Historical perspective on OEO services

1.1 *Early OEO Business Model*

The OEO business model was launched in Canada in the early 2000s through exemptive relief granted by the Investment Dealers Association (IIROC’s predecessor) and several Canadian provincial securities regulatory authorities to certain Dealer Members¹. As set out below, the early OEO business model (**Early OEO Business Model**) was relatively straightforward.

- (a) *Tools*. Generally, OEO firms offered clients only trade execution services with little to no ancillary tools.
- (b) *Products*. The products offered were limited primarily to listed securities.
- (c) *Online Business*. Use of the internet was in its infancy and investors were not yet generally comfortable conducting business activities online. A significant portion of OEO client trades were carried out via telephone orders.
- (d) *Cost*. Generally, OEO firms provided lower transaction fees than full-service Dealer Member firms (**Full-Service firms**).
- (e) *Typical Client*. The typical client was an individual who:
 - wanted to make their own investment decisions
 - wanted low transaction fees
 - was comfortable with online or telephone business transactions.

¹ Please refer to footnote 11 of the Guidance for examples.



1.2 IIROC Regulatory Regime

The applicable IIROC rules/guidance governing the OEO business model were implemented in the early 2000s at the time of the Early OEO Business Model. Dealer Member [Rule 1300.1\(t\)](#) (**Rule 1300.1(t)**) sets out the basic framework for OEO activities. Rule 1300.1(t) provides:

- (a) the requirement for Dealer Members to have applied for and received prior approval from IIROC pursuant to Rule 1300.1(w) (**IIROC Preapproval Requirement**); and
- (b) the general rule that when a Dealer Member accepts an order from a client where no recommendation is provided (**No Recommendation Condition**), then the Dealer Member is not required to comply with Rules 1300.1(p), 1300.1(r) and 1300.1(s), to make a determination that the order is suitable for such client (**OEO Suitability Exemption**).

In other words, the OEO Suitability Exemption is only available where the OEO firm does not provide a “recommendation” to the OEO client with respect to an order.

[Rule 3200](#) - *Minimum Requirements for Dealer Members Seeking Approval Under Rule 1300.1(t) to Offer an Order-Execution Only Service* and the Recommendation Notice set out specific rules/guidance relating to the IIROC Preapproval Requirement and the No Recommendation Condition, respectively.²

2. Current OEO Business Model

Currently, there are 28 OEO firms that have met the IIROC Preapproval Requirement and are permitted to carry on business as an OEO firm.

In 2013, IIROC conducted a survey of all OEO firms to identify the types of tools and products being made available to clients (**2013 Survey**). As described below, the 2013 Survey confirmed that the OEO business model has evolved significantly since the Early OEO Business Model.

- (a) *Tools*. In addition to trade execution services, OEO firms now offer, among others, the following tools:
 - hyperlinks to third-party websites that provide recommendations
 - trading tools
 - trade execution tools
 - automatic portfolio rebalancing alerts and tools
 - filtering tools
 - informative tools such as educational tools, research reports, portfolio analyzer tools (sometimes referred to as asset allocation tools) and model portfolios.³
- (b) *Products*. OEO firms no longer limit the products they offer to primarily listed securities. Instead, they now offer a wide range of products, including fixed income products, mutual funds and exchange traded funds (**ETFs**) and complex, risky or illiquid products (e.g.,

² Please refer to Part 1 of the Guidance for a more detailed discussion of the IIROC regulatory regime applicable to OEO activities.

³ Please refer to Section 3.3 of the Guidance for a more detailed description of these and other tools currently being offered by OEO firms.



leveraged and inverse ETFs, contracts for differences, OTC forex, structured products and options and private placements). OEO firms also now offer a broader variety of account types (e.g., registered, margin, tax-free savings and corporate accounts).

- (c) *Online Activities.* There has been a significant increase in the use and functionality of OEO firms' platforms. The public is now significantly more comfortable carrying out business activities online and OEO client telephone orders have significantly decreased.
- (d) *Typical Client.* The OEO client profile remains someone who wants low transaction fees, seeks to make their own investment decisions and is comfortable carrying on business online. We understand that OEO clients now represent a broader cross-section of demographics (e.g., age, gender, etc.) with a significant portion of clients who are retired with the time to oversee and control their investments.

3. Consultations

As a result of the 2013 Survey, we determined that, while many of the tools currently being offered by OEO firms provide valuable assistance and useful investment information to assist clients in their self-directed investment decisions, some of these tools may be seen as a means of providing implicit, if not explicit, recommendations (which violates the No Recommendation Condition).

To explore this further, IIROC established a working group (**OEO Working Group**) in mid-2015 to consider the products and tools offered by OEO firms in the context of the current regulatory framework.

The OEO Working Group's mandate was to help inform our decision on the appropriate regulatory response to address issues raised as a result of the evolving OEO business model and the new tools being offered by OEO firms. The OEO Working Group included IIROC staff and compliance and legal staff from OEO firms and Full-Service firms. IIROC thanks the OEO Working Group members for their participation and valuable insight.

In addition to the OEO Working Group, we conducted extensive consultation with industry participants and associations, investor advocacy groups and other domestic and international regulators.

We also engaged an independent research firm to survey OEO clients to ascertain their views regarding some of the tools OEO firms make available to them. The online survey provided information in the following key areas:

- (a) reasons why OEO clients chose to invest through an OEO firm
 - the primary reason was cost as using a Full-Service firm was considered too costly
- (b) the extent to which OEO clients believe they are receiving advice/recommendations from OEO firms through certain investment tools
 - of the three tools presented in the survey – asset allocation tools, tools providing lists of securities (pick list portfolio) and automated model portfolio – automated model portfolios are most believed to provide advice/recommendations
- (c) perceptions of OEO clients regarding the receipt of advice from OEO firms and the extent to which they wish to receive, or are reliant upon, investment tools



- less than 1 in 10 OEO clients report that they have adjusted their portfolios as a result of using a mentioned tool; however, those clients using a tool appreciate their availability
 - the findings suggest that at least some OEO clients are using these tools as a substitute for investing through a Full-Service firm
- (d) the extent, if any, to which clients would hold the OEO firm liable in the event of losses
- OEO clients are unlikely to lodge a complaint in the event of a sizeable loss; however, the majority of those who have used/considered using a tool believe that OEO firms could and should be held financially responsible (fully or at least partially) in the event of a sizeable investment loss resulting from the use of the tool.

4. Broader Changes Impacting the OEO Business Model

There have been a number of broader changes which have impacted the OEO business more generally:

- (a) *Investor Confidence with Online Activities.* Investor confidence with carrying on business activities online has led to a broader demographic of client comfortable carrying on online investment activities through an OEO firm.
- (b) *Advice Gap.* Unlike OEO firms (who are subject to the No Recommendation Condition), Full-Service firms can provide recommendations to clients. Many Full-Service firms have implemented asset-under-management (**AUM**) minimum thresholds for new clients. The result is that investors who do not meet these AUM thresholds are unable to become clients of Full-Service firms and must turn to other options, such as OEO firms, to meet their investment needs. Since OEO firms cannot provide recommendations/advice to clients, investors with lower amounts of investable assets may be unable to receive investment recommendations; hence the “advice gap”.⁴

The development of tools by OEO firms which could be considered to provide advice/recommendations may have been due, in part, to the competitive pressure on OEO firms to provide clients with these tools as means of reducing the “advice gap”.

5. Guidance

We are publishing the Guidance to outline our expectations and requirements applicable to all OEO firms.

The Guidance provides IIFROC’s views on the scope of products, tools and account types that we consider to be consistent with the OEO regulatory framework. In developing the Guidance, we were mindful of the online industry’s evolution and growth. The Guidance reflects IIFROC’s evolution of policy

⁴ Although, it should be noted that the online advisor business model may help to reduce the “advice gap”. See footnote 4 below for additional information regarding online advisors.



thought through a modern interpretation of the term “recommendation”, while remaining consistent with the policy intent of the OEO business model.

We continue to monitor developments in the area of online activities (including online advice⁵) and will consider whether further regulatory responses are necessary.

6. Model Portfolios

A model portfolio tool provides clients (or classes of clients) with examples of portfolios or portfolio distributions which purport to be an appropriate guide for building a portfolio (collectively, **model portfolios**). In paragraph 3.3.9(d) of the Guidance we discuss model portfolio tools and set out our view that model portfolios constitute a recommendation and therefore should not be made available by OEO firms.

Notwithstanding this view, we appreciate the potential usefulness that model portfolios provide to OEO clients. As such, in addition to seeking general comments on the Guidance, we are also seeking comments on the possibility of IIROC granting standardized exemptive relief which would potentially allow OEO firms to make available certain limited model portfolios (referred to as **Permitted Model Portfolios**).⁶ Details regarding what constitutes a Permitted Model Portfolio are set out below in subsection 6.1.

As discussed above, the basic framework for the OEO regulatory model is that the OEO Suitability Exemption is only available where the OEO firm does not provide a “recommendation” to the OEO client with respect to an order. This basic framework is consistent with the general policy position of Canadian securities regulators that any recommendation made by a registrant must be suitable for the client.⁷ The potential granting of exemptive relief by IIROC to allow OEO firms to offer Permitted Model Portfolios without suitability would be a departure from the general policy position.

We would appreciate receiving your views and comments on the potential of standardized exemptive relief (as described below) which would allow OEO firms to provide limited advice/recommendations to clients through the use of Permitted Model Portfolios.

6.1 Permitted Model Portfolios

We set out below the parameters for the possible standardized exemptive which would potentially allow OEO firms to make available Permitted Model Portfolios to their clients.

⁵ In contrast to OEO firms, online advisors are permitted to provide advice/recommendations to clients. Online advisors may carry out online advisory activities through registration with a provincial/territorial securities regulator in Canada (portfolio manager registration) or through the IIROC platform (investment dealer registration meeting the requirements applicable to carrying on managed account activities).

⁶ As a technical matter, the exemptive relief necessary to allow OEO firms to make available Permitted Model Portfolios to clients would be relief that grants OEO firms the equivalent of the OEO Suitability Exemption, notwithstanding that a recommendation has been made.

⁷ For example, see subsection 13.3(1) of NI 31-103 – *Registration Requirements, Exemptions and Ongoing Registrant Obligations* which provides: “[a] registrant must take reasonable steps to ensure that, before it makes a recommendation to or accepts an instruction from a client to buy or sell a security, or makes a purchase or sale of a security for a client’s managed account, the purchase or sale is suitable for the client”.



- (a) *“Push” vs. “Pull”*. All Permitted Model Portfolios would merely be made available on an OEO firm’s website to be “pulled” by the client. OEO firms would never “push” or send a model portfolio to an OEO client or class of clients.
- (b) *Content of Permitted Model Portfolios*. Permitted Model Portfolios would be based solely on the following four criteria (or any combination thereof):
 - (i) Class of Investor
 - (ii) Asset Class
 - (iii) Industry Sector
 - (iv) Time Horizon.

The potential exemptive relief would not be permitted to extend beyond these four criteria. Additional details regarding each of the four criteria are provided below.

- (i) *Class of Investor*. Examples of “Classes of Investors” include, but are not limited to: “Conservative Investor”, “Balanced Investor”, “Aggressive Investor”, or such other name(s) to describe each Class of Investor as determined by an OEO firm.

Regardless of the name used to describe each Class of Investor, an OEO firm would be required to provide a definition for each Class of Investor it uses in its Permitted Model Portfolios.

An OEO firm could not (a) assist a client to determine what Class of Investor he/she is, or (b) advise the client that the OEO firm believes the client to be a particular Class of Investor (e.g., based on asking the client questions, using KYC-type information, data-mining of past client transactions or by any other method).

- (ii) *Asset Class*. OEO firms could use “Asset Class” as a criterion in providing Permitted Model Portfolios. Examples of Asset Classes include, but would not be limited to, “Equities”, “Debt”, “Fixed Income” or such other name(s) for Asset Classes as determined by an OEO firm. Similar to Class of Investor, OEO firms would be required to define each Asset Class used in their Permitted Model Portfolios.

OEO firms would not be permitted to refer to specific securities or issuers in a Permitted Model Portfolio as we consider a model portfolio that names specific securities to be significantly more likely to influence a client’s investment decision regarding a security than a model portfolio that is limited to broader Asset Classes. However, we recognize that tools that filter or list available securities, when coupled with a Permitted Model Portfolio tool, may be useful to clients in identifying those specific securities that are consistent with the Permitted Model Portfolio provided by the OEO firm.

- (iii) *Industry Sector*. OEO firms could use “Industry Sector” as a criterion in providing Permitted Model Portfolios. Examples of Industry Sectors which OEO firms may use in their Permitted Model Portfolios include “Financial Services”, “Agriculture” and “Manufacturing”. OEO firms would be required to define each Industry Sector used in their Permitted Model Portfolios.



- (iv) *Time Horizon.* OEO firms could use “Time Horizon” as a criterion in providing Permitted Model Portfolios. Time Horizons help ensure that OEO clients appreciate whether the Permitted Model Portfolio is designed for “short-term”, “mid-term” or “long-term” investment. OEO firms should define each Time Horizon used in their Permitted Model Portfolios. For example, use of “Short-term Time Horizon” would also include a specific time-period (e.g., “less than 1” or “less than 3 years”) to help ensure that clients understand what OEO firms mean when they use various Time Horizons.

7. Next Steps and Implementation

Following the public comment period, IIROC staff will:

- draft a consolidated response to the comments received
- make revisions to the Guidance to address comments received, where appropriate.

Once finalized, the Guidance will replace the Recommendation Notice effective on a date approximately 6-months from the publication date of the Notice of Approval. The 6-month implementation period is to allow OEO firms sufficient time to evaluate their existing OEO business activities against the Guidance.

If an OEO firm determines that it is conducting business inconsistent with the OEO regulatory framework, we would expect the OEO firm to:

- amend its business model consistent with its regulatory obligations;
- cease such activities; and/or
- apply to IIROC for an appropriate, temporary exemption until the requisite business model changes are implemented.

8. Attachments

[Appendix A](#) – Rules Notice – Guidance Note – *Guidance on Order Execution Only Services and Activities*