

# IIROC NOTICE

**Rules Notice**  
**Request for Comments**  
Dealer Member Rules

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**10-0267**  
**October 8, 2010**

## **Plain language rule re-write project – Financial and Operational Rules, Rules 4100 through 4900**

### **Summary of the nature and purpose of the proposed Rules**

On April 30, 2010, the Board of Directors (“the Board”) of the Investment Industry Regulatory Organization of Canada (“IIROC”) approved the publication for comment of the proposed 4000 series of plain language rules (collectively referred to as the “proposed Rules”).

IIROC has undertaken a project to rewrite its rules in plain language. The primary objective of this project is to develop a set of rules that is clearer and more concise and organized, without changing the rules themselves. In addition, we have identified a number of rules that also require substantive revisions.



The new rules will be submitted to the Board and issued for public comments in 8 tranches. This tranche submitted to the Board and issued for public comments includes the following five sets of substantive and non-substantive change rules:

<b>Rule number and title</b>	<b>Rule type</b>
Rules 4100 and 4200, <i>General Dealer Member Financial Standards</i> ;	Substantive
Rules 4300 and 4400, <i>Protection of Client Assets</i> ;	Substantive
Rules 4500 and 4600, <i>Financing Arrangements</i> ;	Substantive
Rules 4700 and 4800, <i>Operations</i> ; and	Substantive
Rule 4900, <i>Other Internal Control Requirements</i>	Non-substantive

The existing rules relating to *General Dealer Member Financial Standards*, *Protection of Client Assets*, *Financing Arrangements*, and *Operations* have been identified as requiring substantive revision in order to:

- eliminate unnecessary rule provisions;
- clarify IIROC’s expectations with respect to certain rules;
- ensure that the rules reflect current industry practices;
- ensure consistency with other IIROC Dealer Member rules; and
- streamline the decision making and rule interpretation process.

Proposed Rules 4100 and 4200, “*General Member Financial Standards*” are a consolidation of the relevant requirements currently in IIROC Dealer Member Rules 16, 17, 30, 200, 300, 1100, 1400 and 2600.

Proposed Rules 4300 and 4400, “*Protection of Client Assets*” are a consolidation of the relevant requirements currently in IIROC Dealer Member Rules 1, 17, 300, 400, 1200, 2000 and 2600, and Form 1.

Proposed Rules 4500 and 4600, “*Financing Arrangements*” are a consolidation of the relevant requirements currently in IIROC Dealer Member Rules 100, 2200, 3000, and Form 1.

Proposed Rules 4700 and 4800, “*Operations*” are a consolidation of the relevant requirements currently in IIROC Dealer Member Rules 17, 800 and 2300.

Proposed Rule 4900, “*Other Internal Control Requirements*” is a rewrite of current Dealer Member Rule 2600’s Internal Control Policy Statement 8.



## **Issues and specific proposed amendments**

### ***Current rules***

Other than the proposed substantive revisions set out below, the proposed 4000 series of Rules do not create any new obligations for Dealer Members.

### ***Proposed rules***

In addition to the plain language rewrite of the existing requirements to create proposed Rules 4100 and 4200, the following substantive amendments are proposed:

- *Exclusion of discretionary early warning situations from the early warning level 2 frequency test:* The proposed amendment specifically excludes discretionary early warning situations (level 1 and 2) from the early warning level 2 frequency test. The use of the discretionary early warning designation is intended to apply immediately and, once the condition of the Dealer Member is satisfactory, the designation is immediately removed. This designation was never intended to trigger the early warning level 2 frequency test. Without this substantive amendment, a Dealer Member may be classified as being in early warning several months after the situation that triggered the discretionary early warning has been remedied. [4132(1)]
- *Corporation's monthly reporting requirement for early warning levels 1 and 2:* The current rules require IIROC to report monthly to the applicable District Council where a Dealer Member (without naming the Dealer Member) is designated as being in early warning level 1 or 2. There is no ongoing need for this reporting requirement as the District Council plays no role in determining whether to classify a Dealer Member as being in early warning. Further, if a Dealer Member is classified as being in early warning, a hearing process is provided should they wish to appeal any business restriction imposed by IIROC staff. The proposed amendment will eliminate this District Council reporting requirement. [N/A]
- *Cost reimbursement for early warning level 1:* The proposed amendment will extend the early warning level cost reimbursement provision to early warning level 1 situations. The current rule provision only applies to early warning level 2 situations. Under this revised provision, IIROC may require any Dealer Member classified as being in early warning to pay for IIROC's costs and expenses incurred to administer the Dealer Member's early warning situation. [4133(1)]



- *Extending deadline for financial filings:* The proposed amendment gives IIROC the discretion to grant a time extension to a Dealer Member for filing its monthly or annual financial report. The proposed amendment also requires the Dealer Member to make its extension request in writing. This revision is reflective of industry practice. [4152(3)]
- *Approval of list of approved auditors:* The proposed amendment would give IIROC the authority to assemble the list of audit firms that are approved to audit IIROC Dealer Members. The current rule requires District Council approval of the list of approved audit firms. [4171(1) and (2)]
- *Review the Dealer Member’s position balancing and account reconciliations:* The proposed amendments replace the term “commodity and option contracts” with the term “derivatives” and replace the term “mutual funds” with the term “non-certificated instruments”. These revisions allow the position balancing and reconciliation requirements to be extended to other derivatives and non-certificated instruments. [4179(1)]
- *Obtain written positive confirmations:* The proposed amendments replace the term “commodity and option contracts” with the term “derivatives” and replace the term “mutual funds” with the term “non-certificated instruments”. These revisions allow the confirmation requirements to be extended to other derivatives and non-certificated instruments. [4182(1)]
- *Bond quotations to the press under IIROC’s name:* The proposed amendment no longer requires a Dealer Member who provides bond quotations to the press to provide those bond quotations under IIROC’s name. The requirement was removed because IIROC no longer plays a role in the pricing of bonds. [N/A]

In addition to the plain language rewrite of existing requirements to create proposed Rules 4300 and 4400, the following substantive amendments are proposed:

- *Fully paid and excess margin securities:* The proposed rule clarifies IIROC’s expectation that a Dealer Member may only use a client’s fully paid and excess margin securities if it obtains the express written approval of the client through the execution of a cash and securities loan agreement. The current requirements do not explicitly describe the circumstances under which a Dealer Member may use a client’s fully paid and excess margin securities; rather they simply state that these securities are not to be used improperly by the Dealer Member. [4312(2)]



- *Records of segregated securities:* The proposed rule clarifies IIROC’s expectation that the description of the segregated securities must be in substance a fair representation of how the securities are being held in segregation at a custodian. The current requirements specify how segregated securities are to be described on a Dealer Member’s security position record (or related records) and customer’s ledger and statement of account, but do not specify that these records and accounts must be a fair representation of how these securities are held at a custodian. [4328(1)]
- *Annual approval of foreign institutions or securities dealers as an acceptable securities location:* The proposed rule clarifies IIROC’s expectations that the annual approval of foreign institutions and foreign securities dealers as “acceptable securities locations” must be evidenced within the Dealer Member Board of Director minutes. The current requirements for auditors allude to an annual Board of Director approval but do not specify how this approval is to be documented. [4350(2)]
- *Custodial indemnification clause:* The current rules for Dealer Member custodial agreements require the inclusion of three minimum agreement clauses. The standard form custodial agreement published by IIROC includes a fourth clause not specified within the current rules. This fourth clause provides important added protection to a Dealer Member by requiring that the custodian indemnify the Dealer Member against any and all Dealer Member losses that result from the custodian’s failure to return any securities or property to the Dealer Member. This custodial indemnification clause also limits the custodian’s liability to the market value of the securities or property. Use of this clause is standard industry practice. The proposed rule adds the custodial indemnification clause as a fourth minimum agreement clause. [4352(1)(iv)]
- *Bare trustee custodial agreement:* A bare trustee custodial agreement is a written custodial agreement between IIROC (acting on behalf of all of its Dealer Members) and a custodian outlining the terms upon which book-based security positions are held with the custodian. The current rules require Dealer Members to execute written custodial agreements with all organizations holding securities for their clients but do not specify the bare trustee custodial agreement as an acceptable form of written custodial agreement. The proposed rule recognizes the bare trustee custodial agreement as an acceptable form of written custodial agreement for book-based security holdings and reflects current industry practice. [4353(1)]



- *Annual audit confirmations and difference account:* The current rules require that a Dealer Member's auditor obtain annual positive written confirmation of all security positions held at acceptable securities locations. The rules do not state what must be done if the confirmation is not received. Comparable current rules for securities held at transfer locations require that, after a certain number of days, the unconfirmed positions be moved to a difference account and be treated as a segregation deficiency. The proposed rule reflects current industry practice and ensures consistency with other Dealer Member rules by requiring that the unconfirmed positions be moved to a difference account if a positive annual written confirmation is not received. [4355(2)]
- *Reconciliation of books and records for deposit investment contracts:* The current rules specify that a Dealer Member must provide margin on mutual fund positions if the Dealer Member does not reconcile them on a monthly basis but does not require the same for deposit investment contract (e.g. guaranteed investment certificates) positions. Previous guidance issued does explicitly state that a Dealer Member must reconcile its books and records of its holdings of deposit investment contracts at least monthly with the issuer's records. The proposed rule adds both monthly reconciliation and capital requirements for deposit investment contract positions. This proposed change codifies previously issued guidance and is consistent with the current rule treatment of other investment products. [4360(1)]
- *Insurance reduction application:* The current rules specify that the applicable District Council has the authority, with IIROC's recommendation, to approve a Dealer Member's application to reduce the amount of insurance for a period of six months that the Dealer Member must maintain. The current rules also specify that the applicable District Council, with IIROC's recommendation, has the authority to renew the Dealer Member's insurance reduction application. These proposed changes remove the insurance reduction application and renewal requirements, which have never been used. [N/A]

In addition to the plain language rewrite of existing requirements to create proposed Rules 4500 and 4600, the following substantive amendments are proposed:

- *General collateral:* The proposed rule expands upon the definition of general collateral to specifically include Government of Canada real-return bonds, strips and coupons. This revision is reflective of industry practice and is intended to provide greater flexibility to Dealer Members in negotiating repurchase and reverse repurchase (repo) transactions. [4511(1)(iii)]



- *Marking to market:* The proposed rule ensures consistency with current industry practice for marking to market and the notification of marks. The current requirement specifies that the marking of a counterparty shall be done by 11:30 a.m. (Toronto time) and that the mark-to-market should be done on a net basis rather than marking on a specific issue by issue basis. In practice, these terms are generally handled bilaterally and specified within Standard Industry Agreements. As a result, the proposed rule includes the proviso “unless otherwise agreed by the parties” to account for customized bilateral agreements. [4513(2)]

In addition to the plain language rewrite of existing requirements to create proposed Rules 4700 and 4800, the following substantive amendments are proposed:

- *Annual review and test of business continuity plan:* The proposed amendment adds the requirement for a Dealer Member’s senior management to annually approve the Dealer Member’s business continuity plan. This requirement was set out as an expectation in previous guidance. [4714(1)(ii)]
- *Membership in other trading organizations or associations:* The current rules prohibit a Dealer Member from becoming a member or continuing as a member of any Canadian bond trading organization unless the organization agrees to observe the IIROC rules for trading and delivery of securities. The proposed rule eliminates this prohibition, because it is unnecessary. [N/A]
- *Delivery through CDS:* The current rules state how securities must be delivered through CDS Clearing and Depository Services Inc. (CDS). The proposed rule eliminates these requirements since Dealer Members who are CDS participants are already required to report and settle trades in accordance with CDS’s rules and procedures. [N/A]
- *Use of a clearing corporation:* The current rules require that a Dealer Member who reports a trade to a clearing corporation (such as CDS Clearing and Depository Services Inc.) for settlement must do so in accordance with the requirements of the clearing corporation. The current rules are unclear as to what requirements apply when both trade parties agree to settle a trade without using a clearing corporation. The proposed rules clarify that IIROC’s settlement requirements apply when a trade is to be settled without using a clearing corporation. [4752(3)]
- *Forbidden transactions:* The current rule states that if a Dealer Member is in doubt as to whether a specific type of transaction is forbidden, it is recommended that the Dealer



Member obtain a ruling on a similar hypothetical case from the Chair of the District Council of his or her District. The proposed rule eliminates this requirement, because Dealer Members are already required to ensure their transactions are in compliance with IIROC's rules and securities legislation. [N/A]

- o *Fixed income physical delivery time:* The current rule states that in the case of dealings between Dealer Members in the same municipality, physical delivery by the seller should be completed before 5:30 p.m. on a clearing day if the trade is to be settled outside of a settlement service. The current rule is outdated as a most banking arrangements must be completed before 4:30 p.m. The proposed rule updates the clearing day delivery time to 4:30 p.m. [4761(5)(i)]
- o *Timing in assuming margin responsibility for an account transfer:* The current rule is silent on when the receiving Dealer Member must assume responsibility for margining an account that is in the process of being transferred in. The proposed rule introduces a start date of the earlier of: (i) the date all the assets and money balances have being transferred; and (ii) 10 clearing days after it has received the transfer request from the delivering Dealer Member. [4813(1)]

The full text of the proposed plain language 4000 series of Dealer Member Rules is attached.

### **Rule-making process**

IIROC Staff involved representatives of Dealer Members in the rule development process, through preliminary consultations. Every rule in the proposed 4000 series of rules was available to all Dealer Members for their input through a Members-only website. The Financial Administrators Section and its Capital Formula and Operations Sub-committees also reviewed and provided comment on all substantive change rules within the proposed 4000 series of rules. A number of changes to the draft proposal were made in response to the comments IIROC received through these consultations.

The proposed Rules were approved for publication by the IIROC Board of Directors on April 30, 2010.

The text of proposed plain language 4000 series of rules is set out in Attachment A. The text of guidance notes and instructions relating to the proposed 4000 series of rules is set out in Attachment B. The text of the existing Dealer Member Rules to be repealed is set out in Attachment C. A table of concordance is included as Attachment D.





## **Issues and alternatives considered**

An alternative to the inclusion of the substantive amendments being proposed was to leave the rules substantively as they were prior to the plain language rewrite. IIROC staff considered other pending projects and proposals as well as the extent of the potential substantive changes identified in order to decide which of the substantive changes would be proposed as part of the plain language rule rewrite project. Those substantive changes that were originally identified as part of the plain language rule rewrite project, but which were ultimately excluded from the plain language rewrite project will be pursued as separate rulemaking projects.

## **Proposed Rule classification**

Statements have been made elsewhere as to the nature and effects of the proposed Rules. The purposes of the proposed Rules are to:

- Ensure compliance with securities laws;
- Prevent fraudulent and manipulative acts and practices;
- Promote just and equitable principles of trade and emphasize the duty to act fairly, honestly and in good faith;
- Foster cooperation and coordination with entities engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities;
- Foster fair, equitable and ethical business standards and practices; and
- Promote the protection of investors.

IIROC staff proposes that rules regarding general Dealer Member financial standards, protection of client assets, financing arrangement, operations, and other internal control requirements should be rewritten to reflect actual IIROC expectations, to enhance the clarity of the rule, to ensure consistency with other IIROC Dealer Member rules and to streamline the decision making and rule interpretation process. These amendments are in addition to the plain language rewrite of the existing rule provisions. The Board has determined that the proposed amendments are not contrary to the public interest.

Due to the extent and substantive nature of these proposed amendments, they have been classified as Public Comment Rule proposals.



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

With the proposed 4000 series of plain language Rules, Dealer Members and investors will benefit from the enhanced clarity and certainty in the proposed Rules relating to general Dealer Member financial standards, protection of client assets, financing arrangements, operations, and other internal control requirements.

The proposed Rules will not have any significant effects on Dealer Members or non-Dealer Members, market structure or competition. Furthermore, it is not expected that there will be any significant, increased costs of compliance as a result of the proposed Rules.

The proposed Rules do not impose any burden or constraint on competition or innovation that is not necessary or appropriate in the furtherance of IIROC's regulatory objectives. The proposed Rules do not impose costs or restrictions on the activities of market participants that are disproportionate to the goals of the regulatory objectives sought to be realized.

## **Technological implications and implementation plan**

There should not be significant technological implications for Dealer Members as a result of the proposed amendments. The proposed 4000 series of plain language Rules will be implemented at the same time as the rest of the plain language rules.

## **Attachments**

**[Attachment A](#)** Text of the proposed 4000 series of rules

**[Attachment B](#)** Text of guidance notes and instructions relating to the proposed 4000 series of rules

## **[Attachment C](#)**

Text of the existing relevant provisions of Dealer Member Rules 1, 16, 17, 100, 200, 300, 400, 800, 1100, 1200, 1400, 2000, 2200, 2300, 2600, and 3000

**[Attachment D](#)** Table of Concordance



## **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 within 90 days of the publication of this notice. One copy should be addressed to the attention of:

Answerd Ramcharan  
Specialist, Member Regulation Policy  
Investment Industry Regulatory Organization of Canada  
(416) 943-5850  
[aramcharan@iroc.ca](mailto:aramcharan@iroc.ca)

A second copy should be addressed to the attention of:

Manager of Market Regulation  
Ontario Securities Commission  
20 Queen Street West  
19th Floor, Box 55  
Toronto, Ontario  
M5H 3S8  
[marketregulation@osc.gov.on.ca](mailto: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.iroc.ca](http://www.iroc.ca) under the heading “IIROC Rulebook - Dealer Member Rules - Policy Proposals and Comment Letters Received”).

Questions may be referred to:

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